

# Supreme Court of the United States

OCTOBER TERM, 1944.

---

NEVILLE COKE & CHEMICAL COMPANY,  
*Petitioner,*

*vs.*

COMMISSIONER OF INTERNAL REVENUE,  
*Respondent.*

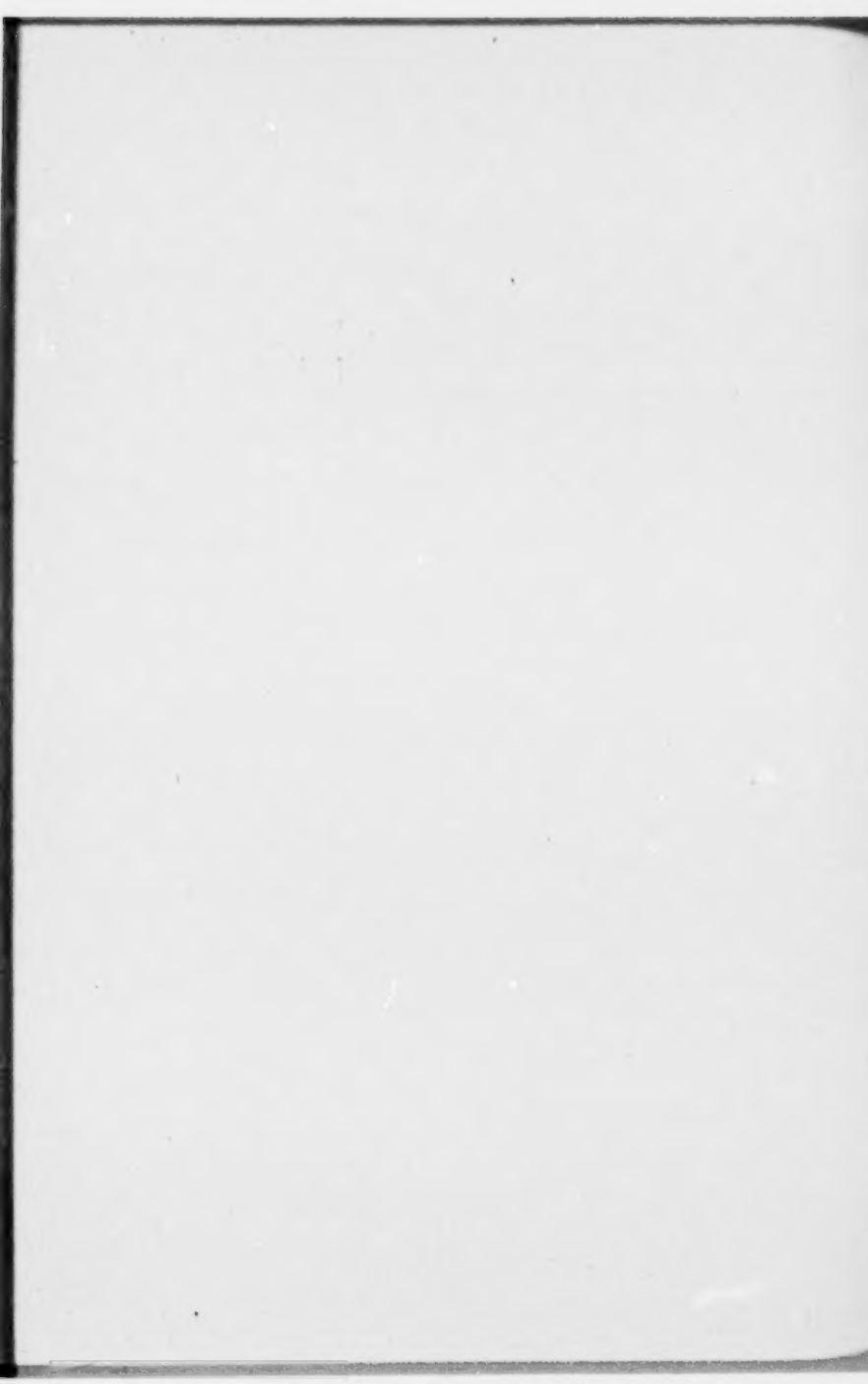
---

---

**PETITION FOR A WRIT OF CERTIORARI TO THE UNITED  
STATES CIRCUIT COURT OF APPEALS FOR THE  
THIRD CIRCUIT AND BRIEF IN SUPPORT THEREOF.**

---

JOHN P. OHL,  
*Counsel for Petitioner.*



# INDEX.

---

	PAGE
PETITION .....	1
Opinions Below .....	1
Jurisdiction .....	2
Question Presented .....	2
Statutes and Regulations Involved.....	2
Statement of Facts.....	3
Reasons for Granting Writ.....	6
Conclusion .....	9
BRIEF IN SUPPORT OF PETITION.....	11
Specifications of Error.....	11
Argument .....	12
I. The decision of the Circuit Court of Appeals is in conflict with the decision of the Circuit Court of Appeals for the Seventh Circuit in <i>Burnham</i> v. <i>Commissioner</i> .....	13
II. The decision of the Circuit Court of Appeals misapplies, and is in conflict with, the decisions of this Court in <i>Pinellas Ice &amp; Cold Storage</i> <i>Company v. Commissioner</i> and <i>LeTulle v. Sco-</i> <i>field</i> .....	15

III. The decision of the Circuit Court of Appeals, holding that corporate notes are not "securities" under the non-recognition provisions of the Revenue Acts, raises a novel and important question of construction of Federal law which should be settled by this Court.....	19
IV. An authoritative determination by this Court of the question whether a corporate note may be a "security" for the purposes of the non-recognition provisions is important to a proper administration of the revenue laws.....	21
CONCLUSION .....	24
APPENDIX A .....	25
APPENDIX B .....	27

## TABLE OF CASES CITED.

<i>Alabama Asphaltic Limestone Co., Helvering v.</i> , 315 U. S. 179 (1942).....	18
<i>Burnham v. Commissioner</i> , 86 F. (2d) 776 (C. C. A. 7th, 1936), cert. denied, 300 U. S. 683 (1937).....	6, 12, 13, 14, 15, 23
<i>Hoagland Corporation v. Commissioner</i> , 121 F. (2d) 962 (C. C. A. 2d, 1941).....	8, 23
<i>LeTulle v. Scofield</i> , 308 U. S. 415 (1940).....	7, 9, 12, 14, 15, 16, 17, 18
<i>Neville Coke &amp; Chemical Co. v. Commissioner</i> , 3 T. C. 113 (1944), aff'd, 148 F. (2d) 599 (C. C. A. 3d, 1945) .....	2
<i>Old Colony Railroad Company v. Commissioner</i> , 284 U. S. 552 (1932).....	19
<i>Pan American Trust Company v. Commissioner</i> , T. C. Memo. Op. C. C. H. Dec. 14, 587 (M), entered May 28, 1945.....	24
<i>Pinellas Ice &amp; Cold Storage Company v. Commis- sioner</i> , 287 U. S. 462 (1933).....	7, 12, 15, 16, 18

## STATUTES.

	PAGE
National Bankruptcy Act, Section 77B, as Amended, 48 Stat. 912 (1934).....	2
Internal Revenue Code, Section 22(b)(9).....	20
Internal Revenue Code, Section 112(b)(10).....	22
Internal Revenue Code, Section 112(e).....	22
Internal Revenue Code, Section 112(l).....	22
Internal Revenue Code, Section 373(f).....	20
Judicial Code, Section 240, as Amended, 43 Stat. 938 (U. S. C., Title 28, Section 347).....	2, 9
Revenue Act of 1928, Section 112(b)(3).....	6, 12, 14
Revenue Act of 1928, Section 112(i).....	17, 18
Revenue Act of 1934, Section 351(b).....	20
Revenue Act of 1936, Section 111(a).....	25
Revenue Act of 1936, Section 111(b).....	25
Revenue Act of 1936, Section 112(a).....	25
Revenue Act of 1936, Section 112(b)(3).....	6, 7, 11, 12, 13, 15, 25
Revenue Act of 1936, Section 112(g)(1).....	4, 26
Revenue Act of 1938, Section 23(k)(3).....	20
Revenue Act of 1939, Section 215(a).....	20
Revenue Act of 1943, Section 121.....	22
Revenue Act of 1943, Section 121(a).....	27
Revenue Act of 1943, Section 121(b).....	27
Revenue Act of 1943, Section 121(e).....	28, 29
Securities Act of 1933, Section 2(1).....	20

## MISCELLANEOUS.

	PAGE
Regulations 94, Article 112(g)-3.....	2, 26
Regulations 111, Section 29.112(l)-2 (b).....	2, 29
G. C. M. 2000, VI-2 C. B. 248 (1927).....	20
G. C. M. 3291, VII-2 C. B. 203 (1928).....	20
Abbott's Dictionary of Terms and Phrases Used in American or English Jurisprudence (1879).....	19
Anderson's Dictionary of Law (1893).....	20
Webster's New International Dictionary.....	19



# Supreme Court of the United States

OCTOBER TERM, 1944

NEVILLE COKE & CHEMICAL COMPANY,  
Petitioner,

*vs.*

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

## PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

*To the Honorable Chief Justice and Associate Justices of  
the Supreme Court of the United States:*

Petitioner, Neville Coke & Chemical Company, by its counsel, prays that a writ of certiorari be issued to review the judgment of the United States Circuit Court of Appeals for the Third Circuit entered in the above entitled cause on March 22, 1945.

### Opinions Below.

This cause originated by the filing of a petition in the United States Board of Tax Appeals (now the Tax Court of the United States) to review the determination of the Commissioner of Internal Revenue that there were deficiencies in petitioner's income and excess profits taxes and a

deficiency and penalty in personal holding company surtax, all for the calendar year 1936. The opinion of the Tax Court redetermining the deficiency was entered on January 25, 1944 and is reported in 3 T. C. 113 (Record, page 3a).

The petitioner petitioned the United States Circuit Court of Appeals for the Third Circuit to review the decision of the Tax Court. The opinion of the Circuit Court of Appeals is reported in 148 F. (2d) 599 (R. 174.....).

### **Jurisdiction.**

The judgment of the Circuit Court of Appeals was entered on March 22, 1945 (R. 181.....). The jurisdiction of this Court is invoked under Section 240 of the Judicial Code, as amended, 43 Stat. 938 (28 U. S. C. § 347).

### **Question Presented.**

The question presented is whether a taxable gain was recognized when petitioner relinquished certain promissory notes of a debtor corporation in exchange for new debentures and common stock of the reorganized corporation, in pursuance of a plan of recapitalization approved by the court in reorganization proceedings under Section 77B of the National Bankruptcy Act, as amended.

### **Statute and Regulations Involved.**

The relevant parts of the Revenue Act of 1936 and Regulations 94 are set forth in Appendix A. Pertinent portions of the Revenue Act of 1943 and Regulations 111 are set forth in Appendix B.

### Statement of Facts.

Petitioner in 1935 was a creditor and stockholder of Davison Coke & Iron Company.\* Petitioner held the following securities of Davison:

Type of Security	Face Value or Number of Shares
First Mortgage Bonds.....	\$ 500,000
Three, Four and Five Year Notes	1,129,000
Prior Preferred Stock.....	15,694
Preferred Stock .....	2,500
Common Stock .....	14,701

Petitioner also held accounts receivable from the debtor corporation (R. 5a, 19a).

The three, four and five year notes had been issued by the debtor in 1932 to its six principal creditors, in pursuance of a voluntary reorganization out of court (R. 4a, 15a, 86a, 89a, 91a-93a, 98a). The notes were dated April 1, 1932, and the four and five year notes bore interest after three years at six percent, payable semi-annually (R. 92a). Each note gave the holder the option to convert up to 50% of the face amount thereof into prior preferred stock of the debtor at its stated value of \$50 per share, such option to be exercised on or before three years from the date of the note (R. 90a-91a, 92a). The principal amount of the three, four and five year notes issued by the debtor aggregated \$1,910,700, which represented a substantial amount of the total investment in the enterprise (R. 6a, Ex. A). Petitioner acquired the debtor's notes

---

\* Now the Pittsburgh Coke & Chemical Company.

held by it upon petitioner's organization in 1933 (R. 4a-5a).

In 1935 the debtor defaulted in the payment of the principal amount of the three year notes and filed a petition in bankruptcy under Section 77B to effect a plan of reorganization (R. 6a). The plan of reorganization approved by the court effected a readjustment of the debtor's capital structure (R. 6a). It is not disputed that the reorganization of the debtor carried out pursuant to said plan constituted a recapitalization and therefore a "reorganization" as defined in Section 112(g)(1) of the Revenue Act of 1936.

Pursuant to the court-approved plan of reorganization, petitioner in 1936 relinquished the following stock, securities and other obligations of the debtor and received in exchange therefor the following:

Items Surrendered		Items Received		
	Face Value or No. of Shares	Debentures (par value)	Stock (No. of Shares)	Notes and Cash
First Mortgage Bonds.....	\$ 400,000.00	\$ 400,000.00	10,000	\$ .....
Three, Four and Five Year Notes.....	1,129,000.00	1,129,000.00	22,580	.....
Accounts Receivable (Preferred) .....	67,884.60	.....	1,273	67,946.87
Accounts Receivable (not Preferred) .....	86,550.00	86,000.00	1,720	576.32
Prior Preferred Stock.....	15,694 shs.	.....	109,465	6.50
Preferred Stock .....	2,500 "	.....	7,500	.....
Common Stock .....	14,701 "	.....	1,470	1.00
		<u>\$1,615,000.00</u>	<u>154,008</u>	<u>\$68,530.69</u>

There is no dispute as to the tax consequences of the exchanges of the bonds, stock and accounts receivable for new debentures, common stock and notes. The only exchange in question is the relinquishment of the notes in consideration of the acquisition of new debentures and common stock of the reorganized debtor. In determining the deficiencies involved in this proceeding respondent held that the gain realized by petitioner upon that exchange was recognized, since the notes did not constitute "securities" within the meaning of Section 112(b)(3) of the Revenue Act of 1936.

Petitioner, on the other hand, claims that the notes relinquished in the exchange were "securities" within the meaning of Section 112(b)(3) and that therefore no gain was recognized upon such exchange.

### **Reasons for Granting the Writ.**

I. The decision of the Circuit Court of Appeals is in conflict with the decision of the Circuit Court of Appeals for the Seventh Circuit in *Burnham v. Commissioner*, 86 F. (2d) 776 (1936), cert. denied, 300 U. S. 683 (1937).

The decision below holds that three, four and five year notes relinquished by petitioner in the 77B reorganization of the debtor in exchange for new debentures and common stock of the reorganized company, were not "securities" under Section 112(b)(3) of the Revenue Act of 1936. On the other hand, in the *Burnham* case, *supra*, the Seventh Circuit held that an unsecured corporate note, exchanged two years after its issuance, was a "security" within the meaning of identical provisions of Section 112(b)(3) of the Revenue Act of 1928.

There is a flat conflict between these two cases. Each case involves an exchange in pursuance of a recapitaliza-

tion, constituting a "reorganization" under identical provisions of the Revenue Acts. Furthermore, the question decided in each case is identical.

II. The decision of the Circuit Court of Appeals misapplies and is an unwarranted extension of the scope of the decisions of this Court in *Pinellas Ice & Cold Storage Company v. Commissioner*, 287 U. S. 462 (1933) and *LeTulle v. Scofield*, 308 U. S. 415 (1940).

In *Pinellas Ice & Cold Storage Company v. Commissioner*, *supra*, this Court first enunciated the doctrine of continuity of interest and applied it to distinguish a taxable sale from a tax-free reorganization. In *LeTulle v. Scofield*, *supra*, this Court, elaborating upon the decision in the *Pinellas* case, added that the doctrine of continuity of interest is not satisfied unless the transferor retains a "proprietary" interest in the transferee. The Circuit Court of Appeals has construed these decisions to require the transferor also to have a "proprietary" interest in the enterprise *prior* to the exchange. Thus, the decision below by this process of reasoning eliminates a creditor's interest from the category of "securities" as used in Section 112(b)(3) of the Revenue Act of 1936.

Petitioner urges that the lower court's decision is a clear misapplication of the *Pinellas* and *LeTulle* cases and should be reviewed by this Court.

III. The decision of the Circuit Court of Appeals, holding that corporate notes are not "securities" under the non-recognition provisions of the Revenue Acts raises a novel and important question of construction of Federal law which should be settled by this Court.

The term "securities" as used in Section 112(b)(3) of the Revenue Act of 1936 was not defined in the Act or the Regulations thereunder, nor in the corresponding provisions

of any prior or subsequent Revenue Act or Regulations. In the absence of an express definition, the language of a statute is to be read in its natural and common meaning. The natural and common meaning of the term "securities" indisputably includes corporate notes and Congress itself has on numerous occasions, in Revenue Acts prior and subsequent to the Revenue Act of 1936, expressly so defined it. Whenever it was intended that the term should have a special or restricted meaning, Congress has provided an express definition for the guidance of the taxpayer and the courts.

IV. An authoritative determination by this Court of the question whether a corporate note may be a "security" for the purposes of the non-recognition provisions of the Revenue Acts is important to a proper administration of the revenue laws.

At the present time the Government is arguing both sides of the question. For example, see *Hoagland Corporation v. Commissioner*, 121 F. (2d) 962 (C. C. A. 2d, 1941), in which the Government contended and the Second Circuit agreed, as an alternative ground of decision, that a demand promissory note was a "security" within the meaning of the non-recognition provisions of the Revenue Act of 1934, which are identical with the non-recognition provisions of the Revenue Act of 1936. Such uncertainty not only greatly increases the expense of administering the tax laws, but imposes a similar additional burden upon the many taxpayers who have relinquished or received corporate notes in connection with exchanges, recapitalizations and reorganizations.

The question whether a corporate note is a "security" is one of continuing importance, for the Revenue Acts prior and subsequent to that of 1936 and the Internal

Revenue Code contain provisions identical with those involved in the instant case. The difficulty and uncertainty of this question were adverted to in *LeTulle v. Scofield*, *supra*, at page 420.

It is submitted that a review by this Court of the instant case would eliminate, both for the Treasury Department and taxpayers, the doubt, uncertainty and burden of litigation which is the result of existing law and particularly of the decision below.

### Conclusion.

WHEREFORE, for the reasons stated above and discussed more fully in the annexed brief, your petitioner prays that a writ of certiorari be issued out of and under the seal of this Honorable Court, directed to the United States Circuit Court of Appeals for the Third Circuit, to the end that the above cause may be certified to and reviewed and determined by this Court as provided in Section 240 of the Judicial Code, as amended, 43 Stat. 938 (28 U. S. C. § 347), and that the judgment of the said Circuit Court of Appeals in the above entitled cause may be reviewed by this Court, and your petitioner prays for such other and further relief as this Court may deem just and proper.

Respectfully submitted,

JOHN P. OHL,  
*Counsel for Petitioner,*  
63 Wall Street,  
New York 5, N. Y.

Dated: New York, N. Y.,

June 22, 1945.



**Supreme Court of the United States**

OCTOBER TERM, 1944.

NEVILLE COKE &amp; CHEMICAL COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

**BRIEF IN SUPPORT OF PETITION FOR  
WRIT OF CERTIORARI.**

The citations of the opinions below, the basis of the jurisdiction of this Court, the statement of facts and the question presented are set forth in the attached Petition, and therefore are not repeated here.

**Specifications of Error.**

The United States Circuit Court of Appeals erred:

(1) in holding that the three, four and five year notes of Davison Coke & Iron Company were not "securities" within the meaning of Section 112(b)(3) of the Revenue Act of 1936;

(2) in holding that the gain realized by petitioner upon the exchange of said notes for new debentures and common stock of the debtor was recognized and taxable in full;

(3) in failing to hold that no gain was recognized to petitioner upon the exchange of said notes, together with first mortgage bonds, prior preferred, preferred and common stocks of Davison Coke & Iron Company for new debentures and common stock of the debtor;

(4) in failing to hold that no gain was recognized and taxable to petitioner upon said exchange; and

(5) in affirming the decision of the Tax Court of the United States.

### Argument.

A writ of certiorari should be issued to review the judgment of the Circuit Court of Appeals for the Third Circuit in the instant case for the following reasons:

1. The decision below holding that corporate notes, relinquished by petitioner in the 77B proceedings for the reorganization of the debtor in exchange for new debentures and common stock of the reorganized company, were not "securities" within the meaning of Section 112(b)(3) of the Revenue Act of 1936, is in conflict with *Burnham v. Commissioner, supra*, where the Seventh Circuit held that an unsecured corporate note, exchanged two years after its issuance, was a "security" within the meaning of identical provisions of the Revenue Act of 1928.

2. The decision below is in conflict with the decisions of this Court in *Pinellas Ice & Coal Storage Company v. Commissioner* and *LeTulle v. Scofield, supra*. The Circuit Court of Appeals has construed these decisions to require a "security" to represent a "proprietary" interest in the corporation, whereas neither decision purports to define the meaning to be attributed to the term "securities" as used in the non-recognition provisions of the tax laws.

3. The decision of the Circuit Court of Appeals holding that corporate notes are not "securities" within the meaning of the non-recognition provisions of the tax laws raises a novel and important question of construction of Federal law which should be reviewed by this Court, particularly as it impinges upon exchanges carried out in connection with creditors' reorganizations in 77B, Chapter X and related proceedings.

4. An authoritative determination by this Court of the question whether a corporate note may be a "security" for the purposes of the non-recognition provisions of the Revenue Acts and Internal Revenue Code is important to a proper administration of the revenue laws.

## I.

**The decision of the Circuit Court of Appeals is in conflict with the decision of the Circuit Court of Appeals for the Seventh Circuit in *Burnham v. Commissioner*.**

The decision below holds that three, four and five year notes, relinquished by petitioner in the 77B reorganization of the debtor in exchange for new debentures and common stock of the reorganized company, were not "securities" under Section 112(b)(3) of the Revenue Act of 1936. This conclusion is in conflict with the Seventh Circuit decision in *Burnham v. Commissioner, supra*.

In the *Burnham* case the taxpayer owned two unsecured notes of a corporation, one for \$402,500 and the other for \$5,000, on which partial payments of \$125,000 had been made. The notes were payable at the option of the maker at any time before their maturity, which was ten years from the date of issuance. These notes were exchanged by the taxpayer, within two years of the date of issuance, for stock of the issuer. The taxpayer claimed a loss on the transaction equal to the difference between the cost basis of the notes and the value of the stock received. The Commissioner of Internal Revenue denied the deduction on the ground that there was an exchange of "stock or securi-

ties" in a corporation a party to a reorganization, solely for "stock or securities" of such corporation, in pursuance of the plan of reorganization, and that on such a transaction no loss was recognized under Section 112(b)(3) of the Revenue Act of 1928.

Section 112 of the Revenue Act of 1928 was, in all respects material in the instant case, identical with Section 112 of the Revenue Act of 1936. Moreover the instant case and the *Burnham* case both involve recapitalizations, and the terms and provisions applicable to both cases are the same. The fact that the term of the obligation in the *Burnham* case exceeded that of the Davison notes does not serve to distinguish the cases, for this Court has said, in *LeTulle v. Scofield*, 308 U. S. 415, 420 (1940), in discussing the classification of securities, that the term of the obligations is not material.

The taxpayer in the *Burnham* case argued that the term "security" included,

"only more formal evidence of property, such as, long-term series notes designed for distribution among investors, bonds, stock, and the like" (33 B. T. A. 149).

The Board of Tax Appeals and the Circuit Court of Appeals rejected this argument and held in favor of the Commissioner that the note was a "security."

The taxpayer applied to this Court for a writ of certiorari. The Commissioner, in opposing the application, stated in his Brief, at page 6:

"The term 'securities', when used without qualification or restriction, as in the statute here involved, includes promissory notes—both in popular speech and in law. See *First National Bank v. United States*, 38 F. (2d) 925, 930 (C. Cl.), affirmed, 283 U. S. 142.

The petitioner would give it a narrower and special meaning, but the language of the statute is to be read in its natural and common meaning. *Old Colony R. Co. v. Commissioner*, 284 U. S. 552, 560."

This Court denied certiorari, 300 U. S. 683 (1937).

The decision of the Circuit Court of Appeals in the instant case is squarely in conflict with the decision of the Seventh Circuit in the *Burnham* case.

## II.

**The decision of the Circuit Court of Appeals misapplies, and is in conflict with, the decisions of this Court in *Pinellas Ice & Cold Storage Company v. Commissioner* and *LeTulle v. Scofield*.**

In support of its conclusion that the notes of the debtor were not "securities" within the meaning of Section 112(b)(3) of the Revenue Act of 1936, the court below cites *Pinellas Ice & Cold Storage Company v. Commissioner* and *LeTulle v. Scofield*, *supra*. Neither of these cases, however, considers the meaning to be given to the term "securities". Both cases apply the doctrine of "continuity of interest", and in each case this Court considered the obligations only in so far as they indicated whether there had been a "reorganization" in the technical sense or whether there had been a taxable sale. In the instant case the debtor was recapitalized and it is not disputed that there was a "reorganization". The only issue is whether the notes were "securities"—a question entirely separate and distinct from questions considered under this Court's interpretation of "reorganization".

The court below, after referring to *LeTulle v. Scofield, supra*, as drawing "the distinction between a case where, after the reorganization, the transferee [*sic*] retained a proprietary interest in the enterprise or simply became a creditor", posed the question:

"Did the notes which the taxpayer held against Davison Company give it a 'proprietary' interest in the enterprise or was it only a creditor?" (R. p. 122)

Thus, the Circuit Court of Appeals adverts to the doctrine of continuity of interest as indicating the meaning to be attributed to the term "securities" as used in the non-recognition provisions of the tax laws. It is clear, however, that the doctrine does not deal with the question whether a corporate note or any other obligation is a "security".

This Court first announced the doctrine of continuity of interest in *Pinellas Ice & Cold Storage Company v. Commissioner, supra*. That case involved a sale by one corporation to another of all its assets for a money consideration to be paid partly in cash and the balance in installments evidenced by short term promissory notes, the longest of which ran for only fifteen weeks. This Court said:

"The court below held that the facts disclosed failed to show a 'reorganization' within the statutory definition. And, in the circumstances, we approve that conclusion.

• • • • •

"• • • the mere purchase for money of the assets of one Company by another is beyond the evident purpose of the provision, and has no real semblance to a merger or consolidation. Certainly, we think that to be within the exemption, the seller must acquire an interest in the affairs of the pur-

chasing company more definite than that incident to ownership of its short-term purchase-money notes" (pp. 469-470).

This case did not hold that the short-term purchase money notes involved were not "securities." It held that the transaction was not a "reorganization" within the statutory definition, but was in fact a sale.

In *LeTulle v. Scofield, supra*, all the assets of one corporation were transferred to another corporation for cash and bonds of the transferee payable serially over a period of eleven years. Immediately after the transfer the entire consideration received by the transferor was distributed to the taxpayer, its sole stockholder. This Court held that the transaction did not qualify as a "reorganization" under Section 112(i) of the Revenue Act of 1928, since the transferor failed to acquire a proprietary interest in the transferee. This Court said:

"In applying our decision in the *Pinellas* case the courts have generally held that receipt of long term bonds as distinguished from short term notes constitutes the retention of an interest in the purchasing corporation. *There has naturally been some difficulty in classifying the securities involved in various cases.*

"We are of opinion that the term of the obligations is not material. Where the consideration is wholly in the transferee's bonds, or part cash and part such bonds, we think it cannot be said that the transferor retains any proprietary interest in the enterprise. On the contrary, he becomes a creditor of the transferee; and we do not think that the fact referred to by the Circuit Court of Appeals, that the bonds were secured solely by the assets transferred and that, upon default, the bondholder would retake

only the property sold, changes his status from that of a creditor to one having a proprietary stake, within the purview of the statute" (pp. 420-421). (*Italics supplied.*)

These cases involve only the definition of the term "reorganization", in substance requiring that the transaction partake of the nature of merger or consolidation, and that there be a continuity of interest in the enterprise. Thus in the *LeTulle* case the Court referred only to Section 112(i) of the Revenue Act of 1928, the section which defines the term reorganization for the purposes of that Act. *That section does not contain the term "securities".*

In all previous cases the continuity of interest doctrine is applied not to what is surrendered or extinguished in the exchange, but to what is received. Since the decision in the *LeTulle* case, it has been assumed that the doctrine requires the *acquisition* of a "proprietary interest" in the enterprise. The Circuit Court of Appeals, however, has construed the doctrine to require the transferor to have a "proprietary interest" in the enterprise *before the exchange*.

The decision of the court below thus makes a novel extension of the continuity of interest doctrine. It is submitted that this decision misapplies the decisions of this Court in the *Pinellas* and *LeTulle* cases and is an unwarranted extension of the scope of those decisions. Moreover, this Court held in *Helvering v. Alabama Asphaltic Limestone Company*, 315 U. S. 179 (1942), that the requirements of the continuity of interest doctrine were satisfied where creditor interests were relinquished in foreclosure proceedings for stock of the new company.

## III.

**The decision of the Circuit Court of Appeals, holding that corporate notes are not "securities" under the non-recognition provisions of the Revenue Acts, raises a novel and important question of construction of Federal law which should be settled by this Court.**

The term "securities" is not defined in the Revenue Act of 1936 or the Regulations thereunder. In the absence of a definition, the language of a statute is to be read in its natural and common meaning (*Old Colony Railroad Co. v. Commissioner*, 284 U. S. 552 (1932)), and the natural and common meaning of the term "security" indisputably comprehends promissory notes. Thus Webster's "New International Dictionary" defines the term as follows:

"That which secures or makes safe. Specif: Something given, deposited, or pledged, to make secure, or certain the fulfillment of an obligation, the payment of a debt, etc.

"Specif: An evidence of debt or of property, as a bond, stock certificate, or other instrument; a document giving the holder the right to demand and receive property not in his possession."

Abbott's "Dictionary of Terms and Phrases used in American or English Jurisprudence" (1879), contains the following statement:

"Securities (plu.) is in use as a general term for written assurances for payment of money; evidences of debt."

Anderson's "A Dictionary of Law" (1893), contains the following definition:

"Securities. Written assurances for the return or payment of money; evidences of indebtedness."

The Bureau of Internal Revenue, in an early ruling based upon an extended analysis of the authorities, concluded that, in the absence of a definition in the statute requiring a special or restricted meaning, the term "securities" included promissory notes in popular acceptance (GCM 2000, VI-2, C.B. 248 (1927)). In GCM 3291, VII-1 C.B. 203, published in 1928, the General Counsel of the Bureau of Internal Revenue ruled, again in the absence of a definition in the statute, that where stock was exchanged for stock and three months debenture notes of the transferee, the debenture notes were securities and the cost of the stock transferred should be allocated to the stock and notes received in proportion to their respective market values. Again in the absence of a definition in the statute, the Treasury Department defined the meaning of the phrase "stock or securities" as used in Section 351(b) of Title 1A of the Revenue Act of 1934, imposing the surtax on personal holding companies, as including "• • • bonds, debentures, certificates of indebtedness, notes • • •" (Regulations 86, Article 351-2(5)). The same definition is continued in the corresponding section of the present regulations (Regulations 111, Section 29.502.1(5)).

Congress itself has repeatedly defined the term "security" as including promissory notes (Securities Act of 1933, Section 2(1); Section 23(k)(3), Revenue Act of 1938; Section 215(a) of the Revenue Act of 1939, amending Section 22(b)(9) of the Internal Revenue Code; Supplement R to the Internal Revenue Code, Section 373(f)).

Further examples of definitions and interpretations of the term "securities" by lexicographers, the Bureau of Internal Revenue, Congress and the courts could be given, but the foregoing make it perfectly clear that the term "securities" includes promissory notes both in common parlance and in law, and further, that when Congress intends to use the term in a special or restricted sense, it provides an express definition for the guidance of the taxpayer and the courts.

The restricted meaning attributed to the term "securities" by the decision below unnecessarily impedes court-supervised corporate readjustments in 77B or Chapter X proceedings. Only by giving the term its natural and commonly accepted meaning can the non-recognition provisions of the tax law be correlated with the provisions governing bankruptcy reorganizations and related proceedings.

#### IV.

**An authoritative determination by this Court of the question whether a corporate note may be a "security" for the purposes of the non-recognition provisions is important to a proper administration of the revenue laws.**

Congress has continued in the Revenue Acts subsequent to 1936, and in the Internal Revenue Code, provisions identical with the exchange provisions of the Revenue Act of 1936 applicable in the instant case. The question whether a corporate note may be a security for the purposes of such provisions is thus a question of continuing and general importance.

The problem has become more important than ever since the enactment of the Revenue Act of 1943. Section 121 of that Act adds Section 112(b)(10) and (l) to the Internal Revenue Code. These provisions are set forth in Appendix B. Section 112(l) provides that "no gain or loss shall be recognized upon . . . the relinquishment or extinguishment of stock or *securities* in a corporation the plan of reorganization of which is approved by the court in a proceeding described in subsection (b) (10) [which includes a 77B or Chapter X proceeding], in consideration of the acquisition solely of stock or *securities* in a corporation . . . made use of to effectuate such plan of reorganization." If the exchange occurred in a taxable year beginning prior to January 1, 1943, as it did in the instant case, then under Section 112(l)(2)(B) the gain or loss is recognized or not recognized "to the extent that it would be recognized or not recognized under the latest treatment of such exchange" by the taxpayer prior to December 15, 1943, in connection with his tax liability for such taxable year.

Section 112(l) is deemed to be included in the Revenue Acts respectively applicable to taxable years beginning after December 31, 1931, as provided by Section 121(e) of the 1943 Act. If the notes relinquished by petitioner for new debentures and common stock of the reorganized debtor are held to be "*securities*", then the provisions retroactively added to the Revenue Act of 1936 by the Revenue Act of 1943 apply.

At the present time, because of the unsettled status of the law, the Treasury Department is forced to argue both sides of the question whether a corporate note may be a security within the meaning of the non-recognition provisions of the tax law, thus greatly increasing the expense of administering the revenue laws. An equal burden is

imposed on the many taxpayers who have given or received corporate notes in connection with exchanges, recapitalizations and reorganizations.

For example, in *Hoagland Corporation v. Helvering*, 121 F. (2d) 962 (C. C. A. 2nd, 1941), the taxpayer owned all the stock and a demand note of a second corporation. There was a reorganization of the latter corporation under Section 77B in which the taxpayer relinquished its stock and note and received in exchange therefor stock of the reorganized corporation.

The taxpayer claimed a loss as a result of the above exchange. The Commissioner of Internal Revenue denied the deduction on the ground that there had been a reorganization. The Commissioner relied primarily upon the *Burnham* case, *supra*, stating in his brief before the Second Circuit:

"The Board also denied petitioner a loss upon the exchange of its promissory note for Class B Stock under the plan of reorganization and in so doing treated the note as being in the same category as the stock of the corporation and as controlled by section 112(b)(3), *infra*. Such a result treats the promissory note as a 'security' of the reorganized corporation upon which no gain or loss is recognized under the reorganization provisions. This holding is supported by *Burnham v. Commissioner*, 86 F. (2d) 776 (C. C. A. 7th), certiorari denied 300 U. S. 683, *which case is squarely in point*.

"\* \* \* It is now established by the decision of the Supreme Court in *LeTulle v. Scofield*, 308 U. S. 415, 420, that the 'term of the obligation is not material.' \* \* \*" (Brief, p. 9). (Italics added.)

The Second Circuit affirmed the Board's decision holding that there had been an exchange of "stock or securities"

in a corporation a party to a reorganization, solely for "stock or securities" of such corporation, in pursuance of the plan of reorganization. Thus, so far the Commissioner has successfully argued that the notes relinquished by petitioner were not "securities" and also has been successful in two other Circuits in taking the opposite view.

The most recent decision of the Tax Court on the question whether corporate notes are "securities" overrules the Commissioner's contention that five year notes redeemable by the maker on 30 days' notice are not securities. *Pan American Trust Company v. Commissioner*, T. C. Memo. Op. C. C. H. Dec. 14,587 (M), entered May 28, 1945.

It is submitted that a review by this Court of the instant case would serve to eliminate the doubt and uncertainty and the resulting burden of litigation, both for the Treasury Department and taxpayers.

### Conclusion.

For the foregoing reasons the decision of the Circuit Court of Appeals should be reviewed by this Court.

Respectfully submitted,

JOHN P. OHL,  
Counsel for Petitioner,  
63 Wall Street,  
New York 5, N. Y.

THOMAS WATSON,  
J. REID HAMBRICK,  
Of Counsel.





## Appendix A.

### Revenue Act of 1936.

#### “SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

“(a) COMPUTATION OF GAIN OR LOSS.—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

“(b) AMOUNT REALIZED.—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

#### “SEC. 112. RECOGNITION OF GAIN OR LOSS.

“(a) GENERAL RULE.—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

“(b) EXCHANGES SOLELY IN KIND.—

. . . . .

“(3) STOCK FOR STOCK ON REORGANIZATION.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

. . . . .

“(g) DEFINITION OF REORGANIZATION.—As used in this section and section 113—

- “(1) The term ‘reorganization’ means \* \* \*
- (D) a recapitalization, \* \* \*.”

#### Regulations 94.

“*Art. 112(g)-3. Exchanges solely of stock or securities, or property, solely for stock or securities, in pursuance of plan of reorganization.*—No taxable income is received, nor is a deductible loss sustained, if the shareholders in a corporation a party to the following reorganization transactions exchange stock or securities solely for stock or securities of the same corporation, or of another corporation mentioned, or if one of such corporations transfers property to another of the corporations solely for stock or securities of such other corporation, in pursuance of the plan of reorganization:

• • • • •

“(5) The exchange of stock or securities solely for stock or securities of the same corporation in the case of (a) a recapitalization of a corporation, \* \* \*.”

## Appendix B.

### Revenue Act of 1943.

#### "SEC. 121. REORGANIZATION OF CERTAIN INSOLVENT CORPORATIONS.

"(a) NONRECOGNITION OF GAIN OR LOSS ON CERTAIN REORGANIZATIONS.—Section 112 (b) (relating to recognition of gain or loss upon certain exchanges) is amended by inserting at the end thereof the following:

"“(10) GAIN OR LOSS NOT RECOGNIZED ON REORGANIZATION OF CORPORATIONS IN CERTAIN RECEIVERSHIP AND BANKRUPTCY PROCEEDINGS.—No gain or loss shall be recognized if property of a corporation (other than a railroad corporation, as defined in section 77m of the National Bankruptcy Act, as amended) is transferred, in a taxable year of such corporation beginning after December 31, 1933, in pursuance of an order of the court having jurisdiction of such corporation—

““(A) in a receivership, foreclosure, or similar proceeding, or

““(B) in a proceeding under section 77B or Chapter X of the National Bankruptcy Act, as amended,

to another corporation organized or made use of to effectuate a plan or reorganization approved by the court in such proceeding, in exchange solely for stock or securities in such other corporation.’

"(b) RECOGNITION OF GAIN OR LOSS OF SECURITY HOLDERS IN CONNECTION WITH CERTAIN CORPORATE REORGANIZATIONS.—Section 112 (relating to recognition of gain or loss) is amended by inserting at the end thereof the following:

"“(1) EXCHANGES BY SECURITY HOLDERS IN CONNECTION WITH CERTAIN CORPORATE REORGANIZATIONS.—

“(1) GENERAL RULE.—No gain or loss shall be recognized upon an exchange consisting of the relinquishment or extinguishment of stock or securities in a corporation the plan of reorganization of which is approved by the court in a proceeding described in subsection (b) (10), in consideration of the acquisition solely of stock or securities in a corporation organized or made use of to effectuate such plan of reorganization.

“(2) EXCHANGE OCCURRING IN TAXABLE YEARS BEGINNING PRIOR TO JANUARY 1, 1943.—If the exchange occurred in a taxable year of the person acquiring such stock or securities beginning prior to January 1, 1943, then, under regulations prescribed by the Commissioner with the approval of the Secretary, gain or loss shall be recognized or not recognized—

“(A) to the extent that it was recognized or not recognized in the final determination of the tax of such person for such taxable year, if such tax was finally determined prior to the ninetieth day after the date of the enactment of the Revenue Act of 1943; or

“(B) in cases to which subparagraph (A) is not applicable, to the extent that it would be recognized or not recognized under the latest treatment of such exchange by such person prior to December 15, 1943, in connection with his tax liability for such taxable year.’

. . . . .

“(e) EFFECTIVE DATE.—Provisions having the effect of the amendments made by subsection (a), subsection (c) (3), and subsection (d) (2), (3), (4), (5), and (6), shall be deemed to be included in the revenue laws respectively applicable to taxable years beginning after December 31, 1933, but shall not affect any tax liability for any taxable year beginning prior to January 1,

1943. Provisions having the effect of the amendments made by subsection (b), subsection (c) (1) and (2), and subsection (d) (1), shall be deemed to be included in the revenue laws respectively applicable to taxable years beginning after December 31, 1931."

### **Regulations.**

"Reg. 111, Sec. 29.112(1)-2. *Recognition of gain or loss upon exchange in taxable year beginning prior to January 1, 1943.*—

. . . . .

"(b) *No final determination prior to May 25, 1944.*— If an exchange described in section 112 (l) (1), or so much of section 112 (c) or (e) as relates to section 112 (l) (1), occurred in a taxable year beginning prior to January 1, 1943, and the tax for such taxable year was not finally determined prior to May 25, 1944, the recognition or nonrecognition of gain or loss shall depend upon the position last maintained by the taxpayer, prior to December 15, 1943, relative to the character of such exchange as one in which the entire amount of gain or loss is recognized or one in which all or a part of the gain or loss is not recognized. For the purposes of this section, such position must have been formally maintained by the taxpayer in his return or amended return for the taxable year, in a claim for refund, in a proceeding before a court or the Tax Court or the Board of Tax Appeals, or in some formal action taken in connection with a determination or proposed determination of his tax liability for such taxable year. If the taxpayer formally maintained that such exchange constituted a transaction upon which the entire amount of the gain or loss is recognized, then gain or loss, in the amount realized upon such exchange, shall be recognized. If the taxpayer formally maintained that such exchange constituted a transaction upon which all or a part of the gain or loss is not recognized, then gain or loss shall not be recognized except to the extent that gain is recognized under section 112 (c)."



# INDEX

	Page
Opinions below.....	1
Jurisdiction.....	1
Question presented.....	2
Statutes and treasury decision involved.....	2
Statement.....	2
Argument.....	5
Conclusion.....	13
Appendix.....	14

## CITATIONS

### Cases:

<i>Bedford, F. T. v. Commissioner</i> , decided July 12, 1945.....	10, 11
<i>Bedford v. Commissioner</i> , decided April 17, 1944 (Tax Court), affirmed July 12, 1945 (C. C. A. 2d).....	13
<i>Burnham v. Commissioner</i> , 86 F. 2d 776, certiorari denied, 300 U. S. 683.....	8, 9, 10
<i>Commissioner v. Neustadt's Trust</i> , 131 F. 2d 528.....	11
<i>Commissioner v. Segall</i> , 114 F. 2d 706, certiorari denied, 313 U. S. 562.....	10
<i>Commissioner v. Sisto F. Corp.</i> , 139 F. 2d 253.....	10
<i>Helvering v. Limestone Co.</i> , 315 U. S. 179.....	11
<i>Helvering v. Watts</i> , 296 U. S. 387.....	7
<i>Hoagland Corp. v. Helvering</i> , 121 F. 2d 962.....	10
<i>Le Tulle v. Scofield</i> , 308 U. S. 415.....	7, 9, 11
<i>Lloyd-Smith v. Commissioner</i> , 116 F. 2d 642, certiorari denied, 313 U. S. 588.....	8, 10, 11
<i>Pinellas Ice Co. v. Commissioner</i> , 287 U. S. 462.....	8, 11

### Statutes:

Internal Revenue Code, Sec. 112 (26 U. S. C. 112).....	12
Revenue Act of 1936, c. 690, 49 Stat. 1648:	
Sec. 111.....	14
Sec. 112.....	5, 6, 7, 11, 12, 14
Revenue Act of 1943, c. 63, 58 Stat. 26, Sec. 121 (26 U. S. C. (Supp. IV) 112).....	15

### Miscellaneous:

T. D. 5402, 1944-18 Int. Rev. Bull. 3.....	13, 16
--	--------

(I)



# **In the Supreme Court of the United States**

OCTOBER TERM, 1945

---

No. 149

NEVILLE COKE & CHEMICAL COMPANY, PETITIONER  
*v.*

COMMISSIONER OF INTERNAL REVENUE

---

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED  
STATES CIRCUIT COURT OF APPEALS FOR THE THIRD  
CIRCUIT*

---

**BRIEF FOR THE RESPONDENT IN OPPOSITION**

---

## **OPINIONS BELOW**

The opinion of the Tax Court of The United States (R. 3a-12a) is reported in 3 T. C. 113. The opinion of the Circuit Court of Appeals (R. 174-181) is reported in 148 F. 2d 599.

## **JURISDICTION**

The judgment of the Circuit Court of Appeals was entered on March 22, 1945 (R. 181). The petition for a writ of certiorari was filed on June 21, 1945. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

**QUESTION PRESENTED**

Whether, under Section 112 (b) (3) of the Revenue Act of 1936, the gain on a transfer by the taxpayer of short term notes, some of which were past due, in exchange for debentures and stock, pursuant to a plan of reorganization of taxpayer's debtor under Section 77B of the Bankruptcy Act, should be recognized.

The answer to this question depends on whether the notes are "securities" within the meaning of Section 112 (b) (3).

**STATUTES AND TREASURY DECISION INVOLVED**

The statutes and treasury decision involved are set out in the Appendix, *infra*, pp. 14-17.

**STATEMENT**

The pertinent facts as stipulated (R. 13a-23a) and as found by the Tax Court (R. 3a-8a) are as follows:

Prior to 1932, the Davison Coke & Iron Company<sup>1</sup> (hereinafter referred to as the "debtor" company) became largely indebted to two companies known as the Hillman Coal & Coke Company (hereinafter referred to as the Hillman Company) and the W. J. Rainey, Inc. (hereinafter referred to as the Rainey Company), for coal sold by those companies on credit, and for certain promissory notes of the debtor company

---

<sup>1</sup> In 1936 the corporate name was changed to Pittsburgh Coke & Iron Company (R. 4a, 14a).

which the Hillman Company had discounted. In 1932 the debtor company, although solvent, was unable to meet its current financial obligations and it therefore entered into a reorganization plan and agreement with its principal creditors. (R. 15a.) Among other things, the plan provided that the date for payment of the indebtedness be extended (R. 4a, 14a-15a), and that certain notes for terms of three, four and five years be accepted by creditors (R. 92a).

On June 8, 1933, the Hillman Company and the Rainey Company caused the taxpayer to be formed under the laws of the State of Delaware (R. 15a) in order to center in it the ownership of their interests in, and the indebtedness due from, the debtor company (R. 4a, 15a). They thereupon transferred to the taxpayer the following assets (R. 16a):

	Face amount or number of shares	Cost to transferees
Preferred accounts receivable due from Davison Coke & Iron Company.....	\$67,884.60	\$67,884.60
First Mortgage bonds of Davison Coke & Iron Company.....	500,000.00	450,000.00
Accounts receivable (not preferred) due from Davison Coke & Iron Company).....	86,550.00	86,550.00
Notes of Davison Coke & Iron Company due in three, four and five years.....	1,129,000.00	1,129,000.00
Stock of Davison Coke & Iron Company Prior Preferred.....	15,694 shs.	0
Preferred.....	2,500 shs.	250,000.00
Common.....	14,701 shs.	8,622.18
		1,992,056.78

As consideration for these assets the taxpayer gave the following (R. 17a):

	To Hillman Coal & Coke Co.	To W. J. Rainey, Inc.	Total
Preferred Stock of Petitioner.....	21,264 shs.	13,726 shs.	34,990 shs.
Common Stock of Petitioner.....	16,610 shs.	25,060 shs.	41,700 shs.
Notes due in five years.....	\$14,908.11	\$52,976.49	\$67,884.60

The above stock and notes were issued to the Hillman and Rainey Companies in proportion to the assets transferred to the taxpayer. The preferred and common stock of taxpayer had equal voting rights: Immediately after the transfer, the transferors owned all of the outstanding capital stock of the taxpayer. (R. 6a, 17a.)

On October 31, 1935, the debtor company filed a petition in bankruptcy, under the provisions of Section 77B of the Bankruptcy Act, to effect a plan of reorganization. On January 31, 1936, the District Court entered its final decree in the proceedings, witnessing the fact that the plan had been fully and completely executed and consummated. (R. 6a, 17a.) The reorganization plan involved an exchange of preferred and common stock for new stock, the exchange of bonds for debentures, and various adjustments of creditors' rights (R. 137a-145a).

One of the readjustments<sup>2</sup> effected under the plan of reorganization was the surrender by the taxpayer of the unsecured three-, four- and five-

<sup>2</sup> As a part of the reorganization, the taxpayer also exchanged bonds, stock, and accounts receivable for new debentures, common stock, notes, and cash. The tax consequences of these exchanges are not in issue.

year notes, issued on April 1, 1932, without interest, in the face amount of \$1,129,000, in exchange for new interest bearing debentures of the same face amount, plus 22,580 shares of new common stock of the debtor company (R. 6a-7a, 18a-19a).<sup>3</sup>

The taxpayer contended that the gain<sup>4</sup> realized upon the exchange of the notes for the new debentures and stock was a non-recognized gain within the purview of Section 112 (b) (3) of the Revenue Act of 1936. The Tax Court sustained the Commissioner's determination that the notes were not "securities" within the meaning of that Section and that the gain was therefore taxable. (R. 8a, 9a.) The Circuit Court of Appeals affirmed (R. 181).

#### ARGUMENT

Subsection (b) of Section 112 of the Revenue Act of 1936 (Appendix, *infra*, pp. 14-15) lists all

---

<sup>3</sup> Of the \$1,129,000 in notes, \$500,000 were three year notes, \$250,000 were four year notes and \$250,000 were five year notes, all having been received by the Hillman Company in 1932 in exchange for \$500,000 demand notes and \$500,000 past due promissory notes (R. 92a). The remaining \$129,000 represented three-year notes received by the Hillman Company and the Rainey Company in 1932 as current creditors of the debtor corporation (R. 98a-99a), apparently for merchandise sold that company.

<sup>4</sup> There is here no dispute as to the Tax Court's findings (R. 8a) that the new debentures had a fair market value, on the date of acquisition, equal to their face value, and that the new common stock received had a value on that date of \$5 per share.

of the exchange transactions in which gain or loss is not recognized and is entitled "Exchanges Solely in Kind." The particular provision under which the taxpayer claims that its exchange of unsecured, short-term notes of its debtor for new debentures and stock is a nontaxable transaction is Section 112 (b) (3), relating to an exchange of stock or securities in a corporation a party to a reorganization, in pursuance of the plan of reorganization, solely for stock or securities in such corporation.

The Tax Court and the court below agreed that there was a recapitalization and, hence, a reorganization within the meaning of Section 112 (g) of the Act (R. 8a, 175-176), but held that the notes here involved were not securities within the meaning of Section 112 (b) (3). The basis of the holding of the court below was that the notes did not represent a "proprietary interest" in the debtor corporation which underwent a recapitalization (R. 177-178.) It is not wholly clear, however, that the court below used the term "proprietary interest" in the sense of a stockholder's interest (R. 178), since the Government had not contended that the term "securities" as used in Section 112 (b) (3) referred only to stock. Nor is that construction of the statute necessary to sustain the decision. It is sufficient if, as the Government contended below, the term "securities" does not include unsecured, temporary evidences of indebtedness which form no part of the capital structure of the corporation.

In *Le Tulle v. Scofield*, 308 U. S. 415, this Court held that a corporation's exchange of assets for bonds and cash was not a nontaxable reorganization within the meaning of Section 112 (b) (4) and (i) (1) (A) of the Revenue Act of 1928, c. 852, 45 Stat. 791, for the reason that the bonds, regardless of their term, did not give to the transferor any proprietary interest in the corporation. It is true, as petitioner suggests, that the Court did not hold that the bonds there involved were not "securities" within the meaning of Section 112 (b) (4), but neither did the Court say or imply that all evidences of indebtedness are securities. It is true also that the Court cited *Helvering v. Watts*, 296 U. S. 387, holding that there is a reorganization where the stockholders of a corporation exchange their stock for a substantial proportion of stock of another corporation in addition to mortgage bonds and, further, that the total consideration received (stock and bonds) is exempt from tax, since both bonds and stock were "securities" within the meaning of Section 203 (b) (2) of the Revenue Act of 1924, c. 234, 43 Stat. 364, and not "other property," within the meaning of Section 203 (e). If, therefore, the Court, in the *Le Tulle* case, approved the *Watts* decision and thus implied that the term "securities" within the meaning of Section 112 (b) (3) and (4) of the 1936 Act or corresponding provisions of the earlier Acts includes mortgage

bonds such as were involved in the *Watts* case, at least where a substantial block of stock is also acquired, the very manner in which that decision is summarized indicates that the term "securities" does not include all evidences of indebtedness of whatever character. This conclusion is fortified by the Court's reference, with apparent approval, to its decision in *Pinellas Ice Co. v. Commissioner*, 287 U. S. 462, where the Court held not only that a transfer of assets for cash and short-term notes was a sale, not a reorganization, but further, that the notes were not "securities." Unless the *Le Tulle* case must be accepted as overruling the decision in the *Watts* case, and as meaning that not even mortgage bonds are to be regarded as securities, within the meaning of Section 112 (b) (4)—an assumption which seems unjustified (see *Lloyd-Smith v. Commissioner*, 116 F. 2d 642 (C. C. A. 2d), certiorari denied, 313 U. S. 588) and one which in no way aids the petitioner—then the decision must be accepted as strengthening, or at least leaving unchanged, the rule previously recognized by this Court and other courts that only secured and/or long-term obligations forming a part of the capital structure of the corporation are "securities" within the meaning of Section 112 (b), whereas unsecured short-term obligations are not (see *Lloyd-Smith v. Commissioner, supra*).

The reasoning of the court in this case and in *Burnham v. Commissioner*, 86 F. 2d 776 (C. C. A. 7th), certiorari denied, 300 U. S. 683, is in conflict

only if the court below actually held that shares of stock alone are securities. In any event, the *Burnham* case is distinguishable on its facts and is not in direct conflict with this case. The *Burnham* decision itself recognized that whether notes were securities depended on all the circumstances of the case (86 F. 2d at 777), and the court's conclusion was based primarily on the ground that the notes exchanged for stock were for a long term, that is, for ten years, only two years of which had expired.<sup>5</sup> Of the total amount of the notes here involved, all issued in April, 1932, \$629,000 was due in three years, \$250,000 in four years, and \$250,000 in five years from that date (R. 92a, 98a-99a, 178). The bulk of them were thus past due at the time of the exchange in 1936, and the remainder had from a few months to less than a year and a half to run. Thus, the notes, when issued, represented not an attempt at permanent financing but, on the contrary, merely a temporary adjustment of indebtedness, and, when the exchange occurred, they were obviously not a part of the capital structure of the corporation.

In any event, since the *Le Tulle* decision the courts have generally held that unsecured promissory notes (particularly those for a short period)

---

<sup>5</sup> In *Le Tulle v. Scofield*, 308 U. S. 415, 420, fn. 7, this Court cited the *Burnham* case, among others, as an instance of the difficulty that had developed in classifying securities in various cases.

are not securities within the meaning of the reorganization provision. *F. T. Bedford v. Commissioner*, decided July 12, 1945 (C. C. A. 2d); *Commissioner v. Sisto F. Corp.*, 139 F. 2d 253 (C. C. A. 2d); *Lloyd-Smith v. Commissioner*, *supra*; *Commissioner v. Segall*, 114 F. 2d 706 (C. C. A. 6th), certiorari denied, 313 U. S. 562. See also, *Hoagland Corp. v. Helvering*, 121 F. 2d 962, 964, in which the Second Circuit Court of Appeals rendered no decision on this point but merely held that whether or not Section 112 (b) (3) applied, the claimed loss was not deductible.<sup>6</sup> On the other hand, in *Commissioner v. Neustadt's*

---

<sup>6</sup> The taxpayer's assertion (Br. 23-24) that in his brief in that case the Commissioner relied primarily upon the *Burnham* decision is erroneous. The Government's brief carefully pointed out (pp. 9-10) that although the decision of the Board of Tax Appeals, holding that notes were securities, was supported by the *Burnham* decision, there were subsequent decisions of other circuit courts of appeals holding that unsecured promissory notes might not be treated as securities within the meaning of Section 112 (b) (3). After citing the cases referred to above in support of that statement, the Government concluded:

Upon the basis of the decisions just cited it appears then that unsecured, promissory notes may not be treated as "securities" within the meaning of Section 112 (b) (3), *infra*.

The Commissioner relied, for affirmance, upon the fact that the taxpayer had failed to prove any basis by which gain or loss might be measured.

It is true, as pointed out by petitioner (Br. 14-15), that in the Government's brief in opposition in the *Burnham* case, No. 778, October Term, 1936, pp. 6-7, the Government took a contrary position as to the meaning of the term "securities." But that was prior to the decision in the *Le Tulle* case.

*Trust*, 131 F. 2d 528 (C. C. A. 2d), the court observed that in the common financial parlance of the business world, a long-term funded debt, represented by convertible debentures, was regarded as forming part of the capital structure of a corporation, and held that the twenty-year debentures there involved were securities.

The argument of the petitioner (Br. 15-18) that the court below has extended the scope of *Le Tulle v. Scofield*, 308 U. S. 415, and *Pinellas Ice Co. v. Commissioner*, 287 U. S. 462, is, we submit, without substance. As the court below pointed out (R. 176-177), the phrase "stock or securities" is used twice in Section 112 (b) (3), once to refer to what is given up and once to refer to what is received. There is nothing in the subdivision to suggest that the two identical phrases have a different meaning. Cf. *Lloyd-Smith v. Commissioner*, *supra*. And in *F. T. Bedford v. Commissioner*, *supra*, the Second Circuit agreed with the holding of the court below that the word "securities" has a consistent meaning throughout Section 112 (b) (3).

Nor is the decision below contrary to the holding of this Court in *Helvering v. Limestone Co.*, 315 U. S. 179. Based primarily upon the fact that the three, four and five year notes, which the taxpayer acquired as assignee of the creditors, at no time gave the taxpayer a right of control over the debtor company, the ruling in this case is in

harmony with the *Limestone* decision. In the *Limestone* case, the Court, in deciding whether the physical properties exchanged had the same basis in the hands of the transferee as they had in the hands of the transferor, merely held that a reorganization occurred where the noteholders, by reason of the insolvency of their corporation, had acquired a proprietary interest in the corporation. Here the fact that the noteholders had not succeeded to the rights of stockholders is evidenced by the fact that the stockholders acquired new stock in the company in exchange for existing shares. The noteholders in the instant case received a markedly different kind of interest from that which they held, and there was not an exchange "solely in kind" such as Section 112 (b) was designed to exempt.

Taxpayer contends (Br. 22) that the question presented has become more important because of the addition made by Section 121 of the Revenue Act of 1943 (Appendix, *infra*, pp. 15-16), of subdivision (b) (10) and (l) to Section 112 of the Internal Revenue Code. But these subsections are inapplicable to the type of proceeding here involved and are of limited application. Section 112l (1), which uses the phrase "stock or securities," applies only to the type of proceeding referred to in subsection (b) (10), *i. e.*, to those cases in which the property of the old corporation is transferred to a different corporation or, in the

words of the statute, "to another corporation organized or made use of to effectuate" the court-approved plan of reorganization. See the unreported supplemental memorandum opinion of the Tax Court, April 17, 1944, in *Bedford v. Commissioner* (1944 P-H T. C. Memorandum Decisions Service, par. 44,123), affirmed on July 12, 1945, by the Circuit Court of Appeals for the Second Circuit, and T. D. 5402, 1944-18 Int. Rev. Bull. 3 (Appendix, *infra*, pp. 16-17). Construction of these statutes will necessarily require consideration in the particular cases in which they are involved, irrespective of the decision here.

#### CONCLUSION

The decision below is correct. There is no direct conflict and no question is presented which warrants review by this Court. The petition should be denied.

Respectfully submitted.

HUGH B. COX,

*Acting Solicitor General.*

SAMUEL O. CLARK, Jr.,

*Assistant Attorney General.*

SEWALL KEY,

HELEN R. CARLOSS,

MURIEL S. PAUL,

*Special Assistants to the Attorney General.*

JULY 1945.

## APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 111. DETERMINATION OF AMOUNT OF,  
AND RECOGNITION OF, GAIN OR LOSS.

\* \* \* \* \*

(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this title, shall be determined under the provisions of section 112.

\* \* \* \* \*

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

\* \* \* \* \*

(3) *Stock for Stock on Reorganization.*—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(4) *Same—Gain of Corporation.*—No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in

another corporation a party to the reorganization.

\* \* \* \* \*

(g) *Definition of Reorganization.*—As used in this section and section 113—

(1) The term “reorganization” means

\* \* \*

(D) a recapitalization, \* \* \*

\* \* \* \* \*

Revenue Act of 1943, c. 63, 58 Stat. 26:

SEC. 121. REORGANIZATION OF CERTAIN  
INSOLVENT CORPORATIONS.

(a) *Nonrecognition of Gain or Loss on Certain Reorganizations.*—Section 112 (b) (relating to recognition of gain or loss upon certain exchanges) is amended by inserting at the end thereof the following:

“(10) *Gain or loss not recognized on reorganization of corporations in certain receivership and bankruptcy proceedings.*—No gain or loss shall be recognized if property of a corporation (other than a railroad corporation, as defined in section 77m of the National Bankruptcy Act, as amended) is transferred, in a taxable year of such corporation beginning after December 31, 1933, in pursuance of an order of the court having jurisdiction of such corporation—

“(A) in a receivership, foreclosure, or similar proceeding, or

“(B) in a proceeding under section 77B or Chapter X of the National Bankruptcy Act, as amended,

to another corporation organized or made use of to effectuate a plan of reorganization approved by the court in such proceeding, in exchange solely for stock or securities in such other corporation.”

(b) *Recognition of Gain or Loss of Security Holders in Connection with Certain Corporate Reorganizations.*—Section 112 (relating to recognition of gain or loss) is amended by inserting at the end thereof the following:

“(1) *Exchanges by Security Holders in Connection With Certain Corporate Reorganizations.*—

“(1) *General rule.*—No gain or loss shall be recognized upon an exchange consisting of the relinquishment or extinguishment of stock or securities in a corporation the plan of reorganization of which is approved by the court in a proceeding described in subsection (b) (10), in consideration of the acquisition solely of stock or securities in a corporation organized or made use of to effectuate such plan of reorganization.

\* \* \* \* \*

(26 U. S. C. (Supp. IV) 112.)

T. D. 5402, 1944-18 Int. Rev. Bull. 3:

In order to conform Regulations 111 [Part 29, Title 26, Code of Federal Regulations, Cum. Sup.] to section 121 of the Revenue Act of 1943, enacted February 25, 1944, such regulations are amended as follows:

\* \* \* \* \*

Sec. 112 (b) (10) applies only with respect to a reorganization effected in one of two specified types of court proceedings: (1) receivership, foreclosure or similar proceedings, or (2) bankruptcy proceedings under section 77B or Chapter X of the National Bankruptcy Act, as amended. The specific statutory requirements are the transfer of property of a corporation, in pursuance of an order of the court having

jurisdiction of the corporation in such proceeding, to another corporation organized or made use of to effectuate a plan of reorganization approved by the court in such proceeding, in exchange solely for stock or securities in such other corporation. \* \* \*

\* \* \* \* \*

The application of section 112 (b) (10) is to be strictly limited to a transaction of the character set forth in such section. Hence, the section is inapplicable unless there is a bona fide plan of reorganization approved by the court having jurisdiction of the proceeding and the transfer of the property of the insolvent corporation is made pursuant to such plan. It is unnecessary that the transfer be a direct transfer from the insolvent corporation; it is sufficient if the transfer is an integral step in the consummation of the reorganization plan approved by the court. By its terms, the section has no application to a reorganization consummated by adjustment of the capital or debt structure of the insolvent corporation without the transfer of its assets to another corporation.



JUL 27 1945

CHARLES ELMORE CROPLEY

**Supreme Court of the United States**

OCTOBER TERM, 1945.

---

No. 149.

---

NEVILLE COKE &amp; CHEMICAL COMPANY,

*Petitioner,**v.*

COMMISSIONER OF INTERNAL REVENUE.

---

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES  
CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

---

---

**BRIEF FOR PETITIONER IN REPLY.**

---

---

JOHN P. OHL,

*Counsel for Petitioner,*

63 Wall Street,

New York 5, N. Y.



# INDEX.

	PAGE
INTRODUCTION .....	1
CONTINUITY OF INTEREST CONCEPT CONFUSED WITH MEANING OF "SECURITIES" .....	1
RELATION OF "SECURITIES" AND "CONTINUITY OF INTEREST" CONCEPTS .....	6
CONCLUSION .....	7
APPENDIX .....	8

## TABLE OF CASES CITED.

<i>Alabama Asphaltic Limestone Co., Helvering v.</i> , 315 U. S. 179 (1942) .....	4, 5, 6
<i>Burnham v. Commissioner</i> , 86 F. (2d) 776, (C. C. A. 7th, 1936), cert. denied 300 U. S. 683 (1937) .....	5, 6
<i>LeTulle v. Schofield</i> , 308 U. S. 415 (1940) .....	3, 4, 5, 6
<i>Palm Springs Holding Corporation v. Commissioner</i> , 315 U. S. 185 (1942) .....	4, 6
<i>Watts, Helvering v.</i> , 296 U. S. 387 (1935) .....	2

## STATUTES.

Revenue Act of 1936, Section 112(b)(3) .....	1, 2, 6
Revenue Act of 1936, Section 112(g) .....	2

## ARTICLES.

Griswold, "Securities" and "Continuity of Interest" (1945) LVIII Harvard Law Review, 705 .....	1, 6, 7, 8-32
---	---------------



# Supreme Court of the United States

OCTOBER TERM, 1945.

---

No. 149.

---

NEVILLE COKE & CHEMICAL COMPANY,  
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE.

---

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES  
CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.*

---

## BRIEF FOR PETITIONER IN REPLY.

Petitioner would feel remiss in its duty to the Court if it did not point out that the respondent's brief deals with only one of two concepts vital to a decision in the instant case and if it did not call to the Court's attention an excellent recent article by Professor Erwin N. Griswold in the Harvard Law Review entitled "'Securities' and 'Continuity of Interest'—A Suggestion for the Reexamination of Two Concepts in the Reorganization Provisions of the Tax Laws".

### **Continuity of Interest Concept Confused with Meaning of "Securities".**

Respondent has stated the ultimate question for decision (Br., p. 2) as "whether the notes are 'securities' within the meaning of Section 112(b)(3)". But respondent also

points out (Br., p. 6) that "the basis of the holding of the court below was that the notes did not represent a 'proprietary interest' in the debtor corporation which underwent a recapitalization".

The decision below was thus premised upon what was regarded as a lack of a "proprietary interest" in what was relinquished in the exchange. The concept of "continuity of interest", so called, was, therefore, the real basis of the decision. Yet nowhere in the respondent's brief is there any discussion of the rationale or scope of the continuity of interest concept as applied to the instant case.

The respondent's brief states the question for decision simply as to whether the notes relinquished in the exchange were "securities". Yet throughout the brief references to what this Court has said regarding the continuity of interest concept in interpreting Section 112(g) defining "reorganizations" have been assumed to furnish the criterion for the interpretation of the word "securities" in Section 112(b)(3). No consideration has been given to the argument that as the term "securities" in Section 112(b)(3) has not been defined, it should be given its natural and common meaning.

The following admissions in the respondent's brief make the omission of any reference to the continuity of interest concept the more remarkable:

1. That there has been a reorganization—recapitalization (Br., p. 6);

2. That petitioner received stock and debentures (Br., pp. 4-5), both of which meet the requirements of Section 112(b)(3) with respect to the permitted receipt of "stock or securities";

3. That under *Helvering v. Watts*, 296 U. S. 387, where a substantial proportion of stock is received,

the total consideration received (although a portion gives the holder only a "creditor" rather than a "proprietary" interest), is exempted (Br., p. 7).

Consequently the petitioner's alleged failure to comply with the non-recognition provision has been narrowed by the respondent's other admissions to the simple fact that by happenstance it held a "creditor" rather than a "proprietary" interest prior to the exchange.

The court below, as respondent admits (Br., p. 6) held the notes relinquished by petitioner were not "securities" because they did not represent a "proprietary interest". But no creditor obligation is a "proprietary interest", as was clearly held in *LeTulle v. Scofield*, 308 U. S. 415, and it does not transform a "creditor interest" into a "proprietary interest" even if, as in the *LeTulle* case, the "creditor" interest be evidenced by long-term secured bonds.

The respondent clearly feels the embarrassment of the result of the decision below because, after citing what was held (Br., p. 6), an attempt has been made to suggest that the meaning of "proprietary interest" is not clear and then by some unexplained metamorphosis that some evidences of "creditor" interest might be a "proprietary" interest but that "unsecured, temporary evidences of indebtedness which form no part of the capital structure of the corporation" are not. This argument is unsupported assertion.

There is nothing in the record here to support respondent's suggestion that the three, four, and five-year notes which petitioner relinquished were "temporary". Since they were past due and in default at the time of the exchange under the reorganization plan, it is unrealistic to regard them as the equivalent of withdrawable cash at the option of the holder. Moreover, this Court has expressly

stated in the *LeTulle* case, *supra*, that the term of the obligation is immaterial. It is ridiculous to argue under the circumstances here that the notes were "temporary" and therefore not part of the "capital structure", since in fact they were exchanged at a time after the creditors had exercised their rights to control the debtor's affairs.

The Court has in *Helvering v. Alabama Asphaltic Limestone Company*, 315 U. S. 179, indicated the only method by which a "creditor" interest can be transformed into the equivalent of a "proprietary" interest. The holding in that case is summarized in *Palm Springs Holding Corporation v. Commissioner*, 315 U. S. 185, as follows:

"The legal procedure employed by the creditors is not material. The critical facts are that the old corporation was insolvent and that its creditors took steps to obtain effective command over its property. For the reasons stated in *Helvering v. Alabama Asphaltic Limestone Co.*, *supra*, the creditors at that time acquired the equivalent of the proprietary interest of the old equity owner. Accordingly, the continuity of interest test is satisfied."

Respondent attempts to avoid the full force of the *Alabama Asphaltic Limestone Company* decision by suggesting (Br., pp. 11-12) that the creditors, including petitioner, at no time had the right of control over the debtor company because the stockholders of the debtor acquired new stock in the reorganized company.

Certainly it does not follow that because the creditors did not insist upon their full right to exclude all participation of the old stockholders, they must be regarded as relinquishing their entire control. At most, to the extent that the stockholders participated, the creditors waived their right to full priority *pro tanto*.

Respondent says that *Burnham v. Commissioner*, 86 F. (2d) 776, is in conflict with the decision below "only if the court below actually held that shares of stock alone are securities" (Br., pp. 8-9). We submit there is no need to resort to such a strained interpretation of the opinion below on an "only if" stock basis. First, the statutory phrase is "stock or securities". In the second place, the court below clearly stated that its result followed because petitioner gave up in the exchange notes which did not represent a "proprietary interest". No bond, note or other evidence of a debt can give a "proprietary" interest, at least until the creditors enforce their rights as creditors, as was the case in *Alabama Asphaltic Limestone Company, supra*.

Next respondent claims (Br., p. 9) that the *Burnham* case is distinguishable on its facts. What facts make it distinguishable are not specifically stated. Both cases involve unsecured notes. In the *Burnham* case the notes, though not yet due, were payable at the option of the maker, whereas in the instant case the notes were in default and the company insolvent at the time of the exchange. From the standpoint of the possibility of immediate realization of the proceeds of the obligation, the instant case presents an *a fortiori* situation. Both cases involved recapitalizations, and both cases involved identical provisions of the Revenue Act. The only difference is that the notes in the *Burnham* case were ten-year obligations, whereas the notes in the instant case were for three, four and five years when issued. In the light of the *LeTulle* case, *supra*, this is a distinction without a difference. Moreover, the notes in the instant case, when issued, carried with them a right to convert up to 50% of an amount thereof into prior preferred stock of the debtor on or before three years from the date of issue (R. 90-A, 91-A, 92-A). This fact

gives the notes here involved from the outset at least the possibility of being converted into a "proprietary interest". The differences between the facts in the two cases are thus distinctions without essential differences. If anything, the facts in the present case disclose more clearly an original "proprietary interest" than those in the *Burnham* case.

### **Relation of "Securities" and "Continuity of Interest" Concepts.**

The decision below misapplies the continuity of interest concept to what is relinquished. In all previous cases, this Court has applied the continuity of interest doctrine not to what is surrendered or relinquished but only to what is received. Since the decision of the *LeTulle* case, *supra*, it has been settled doctrine that there must be the acquisition of a "proprietary interest" in the continuing enterprise. *Helvering v. Alabama Asphaltic Limestone Company* and *Palm Springs Holding Corporation v. Commissioner*, *supra*, found the requirement of the continuity of interest doctrine was satisfied where creditor interests were relinquished and there was an acquisition of a proprietary interest in the reorganized venture.

It is a fundamental misconception to argue that what this Court has said regarding the continuity of interest doctrine automatically defines the limits of the word "securities" used in Section 112(b)(3). The true relation between the concepts of what are "securities" under 112(b)(3) and the continuity of interest doctrine has recently been made the subject of a critical analysis by Professor Erwin N. Griswold in the Harvard Law Review entitled "'Securities' and 'Continuity of Interest'—A Suggestion for the Reexamination of Two Concepts in the Reorganization Provisions of the Tax Laws" (Vol. LVIII

Harvard Law Review, p. 705). For the convenience of the Court, Professor Griswold's recent article is reproduced in the Appendix.

The desirability of a consideration by this Court of the issue raised by the instant case is well summed up by Professor Griswold's concluding remark:

"The argument of this article is that the statute has been denied effect in a situation to which it clearly should apply because of a combination of (1) an original confusion in the *Pinellas* case between the continuity of interest test and the definition of the word 'security,' and (2) a literal and uncritical application of the construction of that word resulting from the confusion. If there is any merit in these contentions, it is not yet too late to recognize that the lowly creditors of a corporation have an interest fully within the purpose of the reorganization provisions of the statute. Bondholders have such an interest. Stockholders have such an interest. Is there any reason at all why noteholders and other creditors, lying in between, should not have exactly the same status?"

### Conclusion.

For the reasons stated in the petitions and briefs, the decision of the Circuit Court of Appeals should be reviewed by this Court.

Respectfully submitted,

JOHN P. OHL,  
Counsel for Petitioner,  
63 Wall Street,  
New York 5, N. Y.

THOMAS WATSON,  
ROBERT C. BROWN,  
Of Counsel.

## Appendix.

### "SECURITIES" AND "CONTINUITY OF INTEREST"

#### A SUGGESTION FOR THE REEXAMINATION OF TWO CONCEPTS IN THE REORGANIZATION PROVISIONS OF THE TAX LAWS.

Some years ago the question was asked in connection with the reorganization provisions of the Federal tax laws "whether verbal competition with life is a paying proposition."<sup>1</sup> Certainly the reorganization sections present the problem of fitting language to concrete cases in one of its most involved forms. The courts have wrestled manfully with these provisions, and to a considerable extent have achieved a construction which harmonizes them with their basic objective and purpose. But there is one situation in which a literalism, faithful not to the statute itself, but to an unnecessary construction of the statute, has been allowed to go far towards preventing the statute from being applied to cases which seem to be clearly within its intended scope.

This construction is illustrated by the recent decision in *Neville Coke & Chemical Co. v. Commissioner*.<sup>2</sup> That case involved a typical creditor's reorganization, the interest of the particular creditor in question being represented by three, four, and five-year notes. The debtor corporation was recapitalized, and the creditor received, in exchange for its notes, new debentures and common stock. Section 112(b)(3) of the Revenue Act of 1936 provided that: "No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged

---

<sup>1</sup> PAUL, *Reorganizations* in STUDIES IN FEDERAL TAXATION, THIRD SERIES (1940) 3, n.4.

<sup>2</sup> C. C. A. 3d, March 22, 1945.

solely for stock or securities in such corporation. . . ."<sup>3</sup> But the court held that the gain on the exchange was taxable on the ground that the notes which the taxpayer gave up were not "securities" within the meaning of the statute.<sup>4</sup> In reaching this result, the court said:

It is to be noted that the phrase "stock or securities" appears twice in §112(b)(3). Once it refers to what a party turns into a corporation being reorganized. The second appearance of the phrase relates to what a recipient takes from the reorganized company as a result of the transaction. We have no reason for thinking that the phrase has a different meaning in either of the two instances and the argument by the taxpayer that it does differ fails to convince us.

The court then concluded that notes received on an exchange were not "securities," citing *Pinellas Ice & Cold Storage Co. v. Commissioner*.<sup>5</sup> It added that neither notes nor any other form of debt interest represented a "proprietary interest in the enterprise," relying on *Le Tulle v. Scofield*.<sup>6</sup> On these apparently clear foundations, it rested its conclusion that the notes given up by the taxpayer in the *Neville* case did not fall within the statute. If the premises are sound, the conclusion no doubt follows. The purpose of this article is to suggest that the time has come to reexamine the premises. Are notes "securities" within the meaning of the statute? Did the Supreme Court really

---

<sup>3</sup> INT. REV. CODE § 112(b)(3) is the same.

<sup>4</sup> It would follow equally that a loss on such an exchange would be recognized. This, however, will often be of little or no value to the taxpayer because of the limitations on the deductibility of capital losses. Indeed, the taxpayer will often desire to show that the loss on the exchange should not be recognized in order to put his eventual loss into another year when he can offset it against gains. Cf. note 45 *infra*.

<sup>5</sup> 287 U. S. 462 (1933).

<sup>6</sup> 308 U. S. 415 (1940).

decide that question definitely in the *Pinellas* case? What is the function and scope of the "continuity of interest" requirement? Did *Le Tulle v. Scofield* decide that that test can never be met by a debt interest on either side of the exchange?

### *The Pinellas Case.*

Our investigation of these questions will naturally begin with the *Pinellas* case itself, which was decided by the Supreme Court in 1933. The *Pinellas* company was engaged in the ice business in Florida. It transferred its assets to the Citizen's Company and received in exchange \$400,000 in cash, and \$1,000,000 in three notes, payable monthly over a period of three and one-half months. The cash was used to discharge debts and obligations of the *Pinellas* company. The notes were held until they were paid off, when the proceeds were distributed to the *Pinellas* stockholders.

The question for decision was whether the *Pinellas* company was taxable on the gain realized on the transaction. This turned on the construction and application of three paragraphs in the Revenue Act of 1926. The first of these was the definition of a "reorganization" in Section 203(h)(1) of the Act as "a merger or consolidation (including the acquisition by one corporation of . . . substantially all the properties of another corporation)."<sup>7</sup>

The second provision was Section 203(b)(3), under which: "No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or

---

<sup>7</sup> The definition of a reorganization is now included in INT. REV. CODE § 112(g). The provision as to mergers now applies only to "a statutory merger or consolidation", without any following parenthetical clause. The acquisition of all of the properties of a corporation is defined as a reorganization in § 112(g)(1)(C), but is limited to cases where the transfer is "in exchange solely for all or a part of its voting stock."

securities in another corporation a party to the reorganization."<sup>8</sup>

Finally, Section 203(e) came into operation. This is the so-called "boot" provision. It provided that where "the property received in exchange consists not only of stock or securities . . . but also of other property or money" the gain should be taxable, in the absence of distribution, but not in excess of the sum of the money "and the fair market value of such other property so received."<sup>9</sup>

The question before the Court in the *Pinellas* case could be approached in either one of two ways: (1) Was the transaction a "reorganization"? If it was not a reorganization, then the gain would be recognized because Section 203(b)(3) was applicable only to exchanges in connection with a reorganization. Or, (2) Were the notes received "securities" within the meaning of Section 203(b)(3)? That paragraph applied only to an exchange of property "solely for stock or securities." *Pinellas* had received no stock. Therefore the transaction was not within the statute unless the notes could be regarded as securities. Under Section 203(e), the notes, if not "securities," would be "other property," and taxable to the extent of their fair market value.

It is obvious that what *Pinellas* had done was essentially to make a sale of its properties. The transaction was not one within the purpose or objective of the reorganization provisions, and it was not surprising that the Court should cast about for a means to construe the statute so as not to grant a tax benefit to such a sale when the gain on the sale for cash would have been taxed in full. The Court made this plain in its opinion, when it said:

---

<sup>8</sup> INT. REV. CODE § 112(b)(4), now in force, is the same. This applies to the recognition of gain or loss on the part of the corporation, which was the question actually involved in the *Pinellas* case. The question of gain or loss to the stock or security holder is essentially the same, and is controlled by the parallel language in INT. REV. CODE § 112(b)(3). See note 3 *supra*.

<sup>9</sup> The corresponding provision now is INT. REV. CODE § 112(d).

It would require clear language to lead us to conclude that Congress intended to grant exemption to one who sells property and for the purchase price accepts well-secured, short-term notes, (all payable within four months), when another who makes a like sale and receives cash certainly would be taxed.<sup>10</sup>

It is not surprising, therefore, that the Court held that the transaction was taxable. The significant point for present purposes is that it placed its result on both of the two grounds indicated above. Its basic decision was that "to be within the exemption the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase-money notes."<sup>11</sup> But is also said that "These notes—mere evidence of obligation to pay the purchase price—were not securities within the intendment of the act and were properly regarded as the equivalent of cash."<sup>12</sup>

In retrospect, it now seems clear that the reference in the *Pinellas* case to the question whether the notes were "securities" or not was both unnecessary and unfortunate. The *Pinellas* case is justly famed as the first clear pronouncement by the Supreme Court of the "continuity of interest" test.<sup>13</sup> When the Court had decided that there was no reorganization, because there was no "merger or consolidation" in the absence of a real continuity of interest, it had decided all that needed to be decided. The decision that the notes were not "securities" was a natural enough one in a case of novel impression where the Court was obviously striving to formulate grounds to prevent the gain on a sale from escaping taxation. But, with the aid of hindsight, it may now be suggested that this reason

<sup>10</sup> 287 U. S. at 469.

<sup>11</sup> *Id.* at 470.

<sup>12</sup> *Id.* at 468-69.

<sup>13</sup> The doctrine was developed a few months earlier in the excellent opinion of A. N. Hand, C.J., in *Cortland Specialty Co. v. Comm'r*, 60 F. (2d) 937 (C. C. A. 2d, 1932), which was cited with approval by the Supreme Court in the *Pinellas* opinion.

was put too broadly. The real basis for the *Pinellas* decision was the complete break in the continuity of the taxpayer's interest in the property transferred. The brief passage in the opinion about securities now appears to have been fundamentally nothing more than another way of stating the continuity of interest test. Although the Court said that the notes were not "securities," one may with reason think that what the Court really had in mind was that the notes were not *such* securities as to meet the continuity of interest requirement which the Court appropriately found in the "merger or consolidation" phrase in the statute.<sup>14</sup>

The history of our law shows many places where a statement has been made which seems perfectly sound in the light of the case then before the court, but which turns out to have been too broad when further cases arise involving different facts. Dean Pound has put the point in an address in general terms, but in language which shows the appropriateness of a further examination into the real basis of the *Pinellas* decision:

When the court has that same state of facts before it, unless there is some very controlling reason, it is expected to adhere to the former decision. But when it goes further and endeavors to formulate a principle, *stare decisis* does not mean that the first

---

<sup>14</sup> The passage in the Supreme Court's opinion in the *Pinellas* case with respect to "securities" was perhaps induced by the Government's brief, for which the present author had some responsibility, and which argued that the notes there involved were not "securities." Though the point was not clearly perceived, the essence of the argument was, however, that the notes were not such securities as to meet the continuity of interest requirement. Cf. the following passage from the brief: "It is implicit in the statute that the transaction shall result merely in a change of form and not in one of substance and that the corporation which has transferred its assets shall receive stock or securities which represent a continuing interest in the assets which have been transferred. Clearly, the notes in this case did not represent any interest of this character." Brief for the Government, p. 19, in *Pinellas Ice & Cold Storage Co. v. Comm'r*, 308 U. S. 415 (1940).

tentative gropings for the principle, what is said in the course of development of the principle by this process of judicial inclusion and exclusion are of binding authority. That explains a great deal. What is commonly spoken of as overruling of decisions, very often there is not an overruling of decision. When a principle has been worked out through this process of judicial inclusion and exclusion, as you look back over the course of development, you can see every case in that line would be decided exactly as it was by the principle finally formulated. But the reasoning may have been revised two, three, four times. What is overruled, therefore, is not a single decision in that line of cases, but the premature, the hasty generalization of a text writer or premature formulation on the part of a court in the beginning of this process.

A good deal of complaint grows out of too much inclination to generalize in a hurry, and too much inclination on the part of text writers to lay down something on the basis of a particular case as a universal proposition. It gets into the encyclopedias, gets reported in the reports, and before you know it, you have something that is a hasty feeling, or groping for a principle masquerading as an established principle in the law.<sup>15</sup>

---

<sup>15</sup> Pound, *Survey of the Conference Problems* (1940) 14 U. OF CIN. L. REV. 324, 330-31. See also Pound, *What of Stare Decisis?* (1941) 10 FORDHAM L. REV. 1, 7-8: "The language of the earlier cases has been repudiated and no doubt ought to have been rejected in the light of further experience. But the results reached remain the same, are consistent throughout the course of decision, and in the end have yielded a workable principle. . . . It cannot be insisted upon too often that our common-law technique does not make the language authoritative, much less of binding authority. It is the result that passes into the law."

Cf. the reference of Taft, C.J., in *Tidal Oil Co. v. Flanagan*, 263 U. S. 444, 454 (1924), to "Certain unguarded language in *Gelpcke v. Dubuque*," and other prior decisions.

### *Bonds as "Securities"*

We may now consider the development of the "securities" virus which was implanted by the *Pinellas* opinion. After an interval of two years, *Helvering v. Watts*<sup>16</sup> came before the Court. In that case the stockholders of corporation X exchanged all of their stock for stock of corporation Y and bonds guaranteed by Y. The Court held that the bonds were "securities", and that no gain or loss was realized on the transaction. The continuity of interest requirement was met because the property received on the exchange included stock in Y.

The *Watts* case made it appear that the line was to be drawn somewhere between long term bonds and short term notes. The lower courts endeavored to draw this line,<sup>17</sup> though with indifferent success, for there was no clear standard nor apparent reason for drawing so sharp a line between these two types of interests. In *Le Tulle v. Scofield*, however, the Supreme Court held that an exchange of stock in X for cash and serial bonds in Y resulted in a taxable gain. The Court said: "We are of opinion that the term of the obligations is not material. Where the consideration is wholly in the transferee's bonds, or part cash and part such bonds, we think it cannot be said that the transferor retains any proprietary interest in the enterprise."<sup>18</sup> On the same day, in *Helvering v. Tyng*,<sup>19</sup> the Court held the gain was taxable when the property received on the exchange was twenty-year bonds.

---

<sup>16</sup> 296 U. S. 387 (1935).

<sup>17</sup> See e.g., *Worcester Salt Co. v. Comm'r*, 75 F. (2d) 251 (C. C. A. 2d, 1935); *Comm'r v. Freund*, 98 F. (2d) 201 (C. C. A. 3d, 1938); *Comm'r v. Tyng*, 106 F. (2d) 55 (C. C. A. 2d, 1939), *rev'd per curiam*, *Helvering v. Tyng*, 308 U. S. 527 (1940); *L. & E. Stirn, Inc. v. Comm'r*, 107 F. (2d) 390 (C. C. A. 2d, 1939); *Karl B. Segall*, 38 B. T. A. 43 (1938), *rev'd*, 114 F. (2d) 706 (C. C. A. 6th, 1940).

<sup>18</sup> 308 U. S. 415, 420-21 (1940).

<sup>19</sup> 308 U. S. 527 (1940), *rev'g per curiam*, *Comm'r v. Tyng*, 106 F. (2d) 55 (C. C. A. 2d, 1939).

It is important to note that the opinion in *Le Tulle v. Scofield* does not refer at all to the question whether the bonds received were "securities" or not.<sup>20</sup> The decision is put solely in terms of continuity of interest. It would be difficult to say that long term bonds were not "securities" within the meaning of the statute. The Court was thus aided in focusing its attention upon the continuity of interest requirement. That this method was used to reach the result in *Le Tulle v. Scofield*, however, makes it seem less likely that the *Pinellas* case should be regarded as really a decision on the "securities" question.

In the light of the *Le Tulle* case, it now becomes clear that it makes no difference whether notes are "securities" or not when we are dealing with the property which is received on an exchange in connection with a reorganization. In either event, a debt interest, no matter what its term, is not sufficient to meet the continuity of interest requirement. On this, the *Pinellas* case is simply *a fortiori* from the *Le Tulle* decision. Indeed, the question is no longer of any particular importance, as the definition of a reorganization in the statute has now been changed so as to include only "a statutory merger or consolidation", or an exchange of property "solely for voting stock".<sup>21</sup> But the question what sort of interests are "securities" continues to be of great importance, for the phrase "stock or securities" still remains, not only in Section 112(b)(3) and 112(b)(4), but it is also to be found in Section 112(b)(5), in Section 112(b)(10), relating to bankruptcy exchanges, and in Sections 113(a)(2), 113(a)(7), 118, 332, and 333(b). It is unfortunate that the word "securities" should be given an unwarranted construction in its use in some or all of these sections, merely because the Supreme Court in the *Pinellas* case, groping for a means to avoid the application of the reorganization statute to a situation which was in all essence a sale, said that notes were not

<sup>20</sup> See Silversøn, *The Meaning of Le Tulle v. Scofield* (1940) 18 TAXES 492.

<sup>21</sup> INT. REV. CODE § 112(g).

"securities", when the real basis of the decision was that the notes did not involve the continuity of interest which now seems a clear and natural requirement of the statute, but which was then a concept in the process of unfolding.

### *Creditors' Reorganizations in Bankruptcy*

The difficulty becomes apparent when we deal with a situation where the note or creditor's interest is on the transferor's side, that is, where the note is included in the property *given up* on the exchange, rather than in the property *received*, as in the *Pinellas* and *Le Tulle* cases. This is the problem of any creditor in connection with a reorganization, and in particular it is the problem in a so-called creditor's reorganization where the creditors of an enterprise, usually induced by force of circumstances, take over its formal ownership and operation. Although this is the type of situation where the reorganization provisions of the tax statute are most clearly justified and needed, the obstacles confronting such an adjustment have been numerous.

The question was first clearly presented in the *Kitselman* case.<sup>22</sup> That was a bondholders' reorganization, where the old bonds were exchanged for bonds and stock in a new corporation. The old stockholders got nothing. The old bondholders sought to deduct their loss, and it was the Government which successfully contended that the transaction was a reorganization. The court held that the bonds were "securities", and as this was prior to the decision of the *Le Tulle* case, it had little difficulty with the continuity of interest requirement.

Despite its victory in the *Kitselman* case, the Government refused to accept the claims of taxpayers that a creditor's reorganization was not taxable when a gain was involved. As it frankly but spinelessly put it, "in the past

<sup>22</sup> *Comm'r v. Kitselman*, 89 F. (2d) 458 (C. C. A. 7th, 1937), cert. denied, 302 U. S. 709 (1937).

See Darrell, *Creditors' Reorganizations and the Federal Income Tax* (1944) 57 HARV. L. REV. 1009.

the Commissioner has taken the position in each case that was necessary to protect the revenues."<sup>23</sup> The Government's arguments in opposing the existence of a tax free reorganization in these cases are logically simple. They run like this: It has been established in the *Pinellas* case that notes are not securities, and in the *Le Tulle* case that bonds do not represent a proprietary interest in an enterprise. It is true that in both of these cases the notes or bonds were on the receiving side, that is, they were among the property received by the taxpayer on the exchange. But, (1) if notes are not securities when received, they cannot be securities when given up on the exchange. And, (2) if bonds do not represent a proprietary interest when received, they cannot represent a proprietary interest when given up. Therefore, there cannot be a tax free exchange of a creditor's interest in connection with a reorganization. If the creditor holds a note or book account, it is not a "security"; and no matter how a creditor's interest is denominated, the requisite continuity of interest cannot be present.

The second of these arguments has been partially demolished by the Supreme Court.<sup>24</sup> In *Helvering v. Alabama Asphaltic Limestone Co.*,<sup>25</sup> a corporation was adjudged a bankrupt. Its creditors bid in its property at the trustees' sale, and the property was transferred to a new corporation. The Government argued that there was no reorganization, because there was no continuity of interest. But the Court held that the creditors became proprietors when they "took steps to enforce their demands against their insolvent debtor".<sup>26</sup> Thus, the former creditors were treated like stockholders, and on this basis it was held that the

---

<sup>23</sup> Brief for the Petitioner, p. 10, in *Helvering v. Southwest Consolidated Corp.*, 315 U. S. 194 (1942).

<sup>24</sup> Congress has also diminished its application by providing for tax free exchanges in connection with all reorganizations in bankruptcy or receivership. See INT. REV. CODE §§ 112(b)(10), 112(1) added by § 121 of the Revenue Act of 1943.

<sup>25</sup> 315 U. S. 179 (1942).

<sup>26</sup> *Id.* at 183.

continuity of interest requirement was met. It is pertinent to observe that in the *Alabama Asphaltic Limestone Co.* case the interests of the creditors were represented by unsecured notes which had been taken for advances to the old company. The question in the case, however, was the basis of the assets to the new company. Thus, the Court did not have to decide whether the notes were "securities" or not within the meaning of Section 112(b)(3) of the statute.<sup>27</sup>

In the *Alabama Asphaltic Limestone Co.* case, the Court relied heavily on the actual commencement of bankruptcy proceedings.<sup>28</sup> This has caused some subsequent difficulties, particularly on the question whether the commencement of bankruptcy was itself a taxable event.<sup>29</sup> It is suggested, however, that all of these difficulties will disappear if the continuity of interest requirement in connection with bondholders' and creditors' reorganizations is subjected to a careful reexamination.

### *"Continuity of Interest"*

The basic difficulty arises, it may be thought, because of the apparently logical proposition that since bonds (or other debt interest) cannot meet the continuity of interest requirement when received on the exchange, they cannot

---

<sup>27</sup> It may be pointed out, however, in connection with the argument which follows, that it would be at least incongruous to hold that the transaction was tax free as far as the corporation was concerned, so that the old basis carried forward to the new company, and at the same time to hold that the transaction was not tax free as far as the creditors were concerned, so that a gain or loss would be recognized on their exchange, and a new basis attach to the securities which they received. Recognition that the notes are "securities" would eliminate this difficulty.

<sup>28</sup> See also *Helvering v. Cement Investors, Inc.*, 316 U. S. 527 (1942). This view was adopted in *Bunker Hill & Sullivan Mining Co.*, 1 T. C. 1057, 1076 (1943), where the court said: "Until a court of equity intervenes stockholders and creditors of a corporation are not the owners of the corporate assets, notwithstanding the insolvency of the corporation."

<sup>29</sup> Cf. *Helvering v. Cement Investors, Inc.*, 316 U. S. 527, 534-35 (1942); *John Wanamaker Philadelphia v. Comm'r*, 139 F. (2d) 644, 648-49 (C. C. A. 3d, 1943).

meet that requirement when given up on the exchange. In order to meet this syllogism, the *Alabama Asphaltic Limestone Co.* opinion had to develop the elaborate, rather mechanical, and certainly troublesome notion of a transformation of the creditor's interest into a proprietary interest by the commencement of bankruptcy proceedings. May not the answer really be simpler than that? Is the basic syllogism sound? Is it really clear that because notes and bonds do not meet the continuity of interest test when they are received on an exchange, there can be no continuity of interest when notes and bonds are the property given up?

There would seem to be room to assert that this proposition is by no means clear. What is "continuity of interest"? The heart of the notion would seem to be in the basic word "continue". It is a progression, a going forward, not an equation. It does not make any difference what you start with. Whether there is a continuity of interest depends upon the "continuity", that is, upon what happens to what you start with, not on the interest which is the origin of the process. If you end up with notes or bonds in a solvent enterprise, the *Pinellas* and *Le Tulle* cases rightly hold that the continuity is broken. But if you end up with a stock interest, you have maintained the continuity, no matter what you start with. The creditor or the bondholder has an interest in the old enterprise. No one could deny that. It is true even when the old enterprise is solvent. It is certainly true when the old enterprise is insolvent, regardless of whether bankruptcy proceedings have actually been commenced or not. The basic question should be the continuity of that interest. Why should it make any difference whether the interest which is given up on the reorganization is a "proprietary" interest, or not a "proprietary" interest? That line is indistinct at best, and in any event, the creditor certainly has an interest, a stake, some sort of property, in the enterprise. Whatever it is, if he gives it up, and receives stock, his interest continues. That actual result in fact does not depend upon the nature of the interest

with which he started, nor upon the actual commencement of foreclosure or bankruptcy proceedings. The latter are possible, but not necessary, steps in the process. Whether there is continuity of interest or not *does* depend upon what the transferor *receives* on the exchange; but it does not depend upon what he starts with, upon what he *gives up* on the exchange. It is a one-way reaction. The fact that the receipt of bonds or notes will break the continuity no matter what you start with, does not mean that there cannot be complete continuity of interest if you start with notes or bonds and end up with something else.

It is argued, therefore, that the continuity of interest requirement should be concerned solely with what is *received* on the exchange, and not at all with what is given up. On this basis, it would follow that all creditors' reorganizations meet the continuity of interest test when the creditors end up as stockholders, regardless of whether the creditors were note holders or bondholders, or creditors on open account, and regardless of whether bankruptcy or receivership proceedings have actually been commenced. As a merely factual matter, why should there be any question about this? On the whole, the creditors of an embarrassed enterprise ordinarily deserve somewhat more consideration than the stockholders. They not only have a stake in the enterprise, but one which ranks ahead of the stockholders. They ordinarily have acquired their interest with the expectation that they will be paid in cash or its equivalent. But there are risks in any enterprise, and creditors often find that their investment is thoroughly frozen. They would gladly take cash if they could, and get out. But there is no cash for them. Their claim for cash has become merged in the enterprise. They have to work their way out of the situation the best they can. And if they project their interest into a new corporation in exchange for that corporation's stock, they would seem to be precisely the sort of persons for whom the reorganization provisions were basically designed. They are not realizing on their interests. They are merely regularizing a

situation which has been thrust upon them, formally recognizing that their position as creditors has evaporated and that they have in essence become the owners of the enterprise. But when they take stock in the new corporation the continuity of their interest is unabated. Indeed, the fact of the *continuity* is accentuated by the very change from debt to stock.

### *Recapitalizations*

This conclusion has in effect been reached in the cases involving recapitalizations, as distinguished from transfers to a new corporation, where the property given up on the exchange is bonds. In these cases the continuity of interest requirement has been minimized. That is natural, as the test had its origin in a construction of the words "merger and consolidation" in the definition of a reorganization, and these words have no applicability to a reorganization which is carried out through a recapitalization. On this basis it has been held that there was a tax free reorganization when old preferred stock was exchanged for new bonds,<sup>30</sup> and when old common stock was exchanged for new common stock and bonds.<sup>31</sup> Probably the most striking case is *Commissioner v. Neustadt's Trust*,<sup>32</sup> where there was an

<sup>30</sup> See, e.g., *Lelia S. Kirby*, 35 B. T. A. 578 (1937), *modified on other grounds*, 102 F. (2d) 115 (C. C. A. 5th, 1939); *Clarence J. Schoo*, 47 B. T. A. 459 (1942), *dismissed and aff'd without opinion*, C. C. A. 1st, March 29, 1943; *Redford Lumber Co.*, 42 Prentice-Hall BTA Mem. Serv. ¶ 42,564 (Oct. 21, 1942); *Annis Furs, Inc.*, 2 T. C. 1096 (1943); *Arthur J. Hooks*, 44 Prentice-Hall TC Mem. Serv. ¶ 44,284 (Aug. 22, 1944).

<sup>31</sup> See, e.g., *Edgar M. Docherty*, 47 B. T. A. 462 (1942), *remanded to Tax Court*, C. C. A. 1st, January 12, 1943; *Adam A. Adams*, 4 T. C. No. 140 (April 26, 1945). In the latter case, an order was issued, on May 1, 1945, that the decision be reviewed by the full Tax Court. This may or may not indicate the possibility of some change in the current of the Tax Court's decisions.

<sup>32</sup> 131 F. (2d) 528 (C. C. A. 2d, 1942), *aff'g*, 43 B. T. A. 848 (1941). See also *Edith M. Greenwood*, 41 B. T. A. 664 (1940); *Koppers United Co.*, 43 Prentice-Hall TC Mem. Serv. ¶ 43,231 (May 5, 1943), *aff'd on other issues*, 141 F. (2d) 1023 (C. C. A. 3d, 1944); *Jeanne G. Miller*, 44 Prentice-Hall TC Mem. Serv. ¶ 44,077 (Mar. 14, 1944); *Mary N. Crofoot*, 45 Prentice-Hall TC Mem. Serv. ¶ 45,036 (Jan. 25, 1945).

exchange of twenty-year debentures for new ten-year convertible debentures in the same company. The court held that this was a tax free recapitalization, although it did not affect the capital stock of the company. This would seem to be a sound result. If there is any continuity of interest requirement in recapitalization cases, there would seem to be a real continuity when a bondholder remains a bondholder. When a shareholder becomes a creditor, as in many of these cases, the continuity is not so clear. A rigid application of the *Le Tulle* case would strike these transactions down. But the *Le Tulle* case should not be applied, and has not been applied in these recapitalizations. Congress has not enacted a continuity of interest requirement in terms, and there is no basis for reading it into the word "recapitalization" as there was in the case of the phrase "merger or consolidation".<sup>33</sup>

Nevertheless, there is difficulty, even in the recapitalization cases, when a note is introduced into the picture. Thus, in *Wesley V. E. Terhune*,<sup>34</sup> the holder of preferred stock exchanged it on a recapitalization for cash and a note. Of course the cash was taxable, but the Board held that the note was taxable too. This was not because of any application of the continuity of interest test as such, but because the Board concluded that the note received was not a "security," in accordance with the *Pinellas* case. Thus the Board felt that there was not an exchange of "stock or securities," as required by Section 112(b)(3), even if the transaction was a recapitalization and thus a reorganization. As long as the current doctrine that notes are not "securities" prevails, it would seem to be impossible to have a tax free recapitalization of any corporation, no matter how much such a recapitalization may be needed as a matter of business procedure and convenience, where

---

<sup>33</sup> *Le Tulle v. Scofield* was distinguished on this ground in Clarence J. Schoo, 47 B. T. A. 459 (1942), *dismissed and aff'd without opinion*, C. C. A. 1st, March 29, 1943; and in Mary N. Crofoot, 45 Prentice-Hall TC Mem. Serv. ¶ 45,036 (Jan. 25, 1945).

<sup>34</sup> 40 B. T. A. 750 (1939).

a part of the claims against the corporation is represented by notes, or open accounts, as distinguished from stock or bonds. That is really a curious and incongruous situation.

“Securities”

In many situations it is not enough to know that the transaction qualifies as a reorganization. There will necessarily be some sort of exchange on the transaction, and gain or loss will be recognized unless the exchange involves “stock or securities.” Under Section 112(b)(3), involving the security holder, gain or loss will be recognized unless he both gives up and receives “stock or securities” on the exchange. In the case of a corporation which is a party to a reorganization, and which transfers its property under the plan of reorganization, gain or loss will be recognized under Section 112(b)(4) and Section 112(b)(10) unless it receives “stock or securities” on the exchange.

To date, little or any difficulty has developed in connection with the meaning of the word “stock.” The word “securities” has, however, received a restricted meaning, the sole basis for which is apparently the decision in the *Pinellas* case. Since the phrase is “stock or securities,” it seems fairly clear that “securities” must include something besides “stock.” This was recognized in the *Watts* case<sup>35</sup> where bonds received on an exchange together with stock were held to be “securities,” so that no gain was recognized. Because the transaction involved the receipt of stock as well as of bonds, the continuity of interest requirement was regarded as satisfied, although it is by no means clear how much stock or what proportion of stock must be received to meet that test. When the *Le Tulle* case came before the Court, the *Watts* case made it impossible to hold that bonds were not securities, and thus the decision that the *Le Tulle* transaction was not a reorganization was put solely on the continuity of interest ground.

<sup>35</sup> *Helvering v. Watts*, 296 U. S. 387 (1935). Cited note 16 *supra*.

The net result of these cases is that it has been established that bonds are "securities," while the *Pinellas* case is regarded as holding that notes are not "securities." No one knows just where the line between bonds and notes is to be drawn. Apparently the matter turns a good deal on the terminology which the parties apply to the particular instrument.<sup>36</sup> Remembering that we are not now talking about the continuity of interest requirement, but solely about the question of the meaning of "securities," no reason is perceived why the term of the instrument, or its interest rate, or its status as a lien on the property, or its name, or the elaborateness of its engraving, should have any bearing on the question whether it is a "security."

It is suggested that any debt obligation of any sort in a corporation a party to a reorganization should be treated as a "security" for the purposes of these sections of the tax statute.<sup>37</sup> After all, a note is not money. It is at best an investment, a promise for the payment of money, a claim against an enterprise. If it be said that many notes are readily marketable, and that money can be quickly realized upon them, there are at least two ready answers. (1) The same is often true of stock received on a reorganization exchange, but it is clear that the mere *receipt* of stock, no matter how marketable or how readily convertible into cash, does not make a transaction taxable. (2) If the obligation received is in fact turned into cash, by being sold or otherwise, then there will, of course, be a recognizable gain or loss on that event. But that is no reason for saying

<sup>36</sup> Of course, if it is desired to make the transaction tax free, the parties call the instrument received a bond, and make it look like a bond. In *Mary N. Crofoot*, 45 Prentice-Hall TC Mem. Serv. ¶ 45,036 (Jan. 25, 1945), the property received was twenty-year registered 5% bonds. These were held to be "securities" even though the obligor could call them for payment within two years after issue.

<sup>37</sup> See McLaren, *Do "Securities" Include Notes under Section 203?* (1928) 6 NAT. INCOME TAX MAG. 135. Cf. I. T. 2392, VI-2 CUM. BULL. 17 (1927), where warrants to buy notes in a corporation were held to be "securities" when received on an exchange; G. C. M. 2000, VI-2 CUM. BULL. 248 (1927), where mortgage notes were held to be securities under the Federal Farm Loan Act.

that a gain or loss must be recognized on the receipt of the obligation, while it is still held, while the holder still retains his stake in the enterprise.

It is true that the *Pinellas* opinion gave as one of the grounds for the decision that the notes involved there were not "securities." It has already been argued that, with the benefit of some twelve years of hindsight on the problem, we may now properly conclude that the reason which the Court was striving to formulate was not that the notes were not "securities," but that they were not such "securities" as to fulfill the continuity of interest requirement. The question was not extensively considered in the *Pinellas* case. The only reference to "securities" is in a single sentence in the opinion. It would seem that the time is now ripe for a re-appraisal of the whole problem.

In the cases which have arisen on this point, this aspect of the *Pinellas* decision has been quite automatically applied. Indeed, the cases in this field seem to be rather remarkable for their mechanical approach to the problem without any careful consideration of the structure and the objective of the statute. Nor has this aspect of the *Pinellas* case received careful consideration by any of the several authors who have written in this field.<sup>38</sup> When notes

---

<sup>38</sup> Cf. 3 MERTENS, LAW OF FEDERAL INCOME TAXATION (1942) § 20.60; PAUL, *Reorganizations*, in STUDIES IN FEDERAL TAXATION, THIRD SERIES (1940) 3, 101; Darrell, *Creditors' Reorganizations and the Federal Income Tax* (1944) 57 HARV. L. REV. 1009; Fahey, *Income Tax Definition of "Reorganization"* (1939) 39 COL. L. REV. 933; Silverson, *The Meaning of Le Tulle v. Scofield* (1940) 18 TAXES 492.

The point here made was, however, clearly forecast in a Note, *Continuity of Interest in Reorganization under the Federal Income Tax* (1940) 49 YALE L. J. 1079, 1083-84: "The affinity between the concept of continuity as applied to 'securities' and as applied to the definition of reorganization was recognized by holdings to the effect that bonds satisfied the continuity requirement *because* they were 'securities.'

"The holdings in these last cases were persuasive. If bonds satisfied the continuity requirement for purposes of the exchange and boot provisions, as in the *Watts* case, it seems logical that they would also satisfy it for purposes of the definition. . . . In the light of the

are *received* on the exchange it ordinarily makes little difference whether they are regarded as "securities" or not, as the transaction will not meet the continuity of interest test. But from the premise that notes received are not "securities," based on the *Pinellas* case, it has been determined with rigid logic that notes are not securities when they are given up on the exchange, with the unwarranted and undesirable result that there is apparently no possible way that a noteholder or book creditor of a corporation can enter into an exchange which will be tax free, no matter what sort of interest he receives on the exchange. This structure may well be sound if the premise on which it stands—that notes are not "securities"—is sound. But it would wholly collapse if it should now be perceived that the *Pinellas* case did not need to decide that notes were not securities, and should not now be regarded as having decided anything except the relationship of notes received to the continuity of interest requirement.

In one of the earliest cases in which a note was involved on the transferor's side, that is, where a note was given up on the exchange, the distinction was clearly seen. In *Burnham v. Commissioner*,<sup>39</sup> stockholders in a corporation also held its note. They exchanged the note for new stock and endeavored to deduct a loss. The court held that no loss was deductible because this was an exchange of securities in connection with a recapitalization. Of course, this was before the *Le Tulle* case was decided, but the *Le Tulle* case has no bearing on the "securities" question. In reaching its result, the court distinguished the *Pinellas* and

---

affinity of the two rules, however, there is a danger that the lower courts will impose on the term 'securities' the same requirement of a proprietary interest which the *Le Tulle* case had applied to the definition of a reorganization."

<sup>39</sup> 86 F. (2d) 776 (C. C. A. 7th, 1936), *cert. denied*, 300 U. S. 683 (1937). See also *Martin v. Chandis Securities Co.*, 128 F. (2d) 731 (C. C. A. 9th, 1942); *Comm'r v. Huntzinger*, 137 F. (2d) 128 (C. C. A. 10th, 1943). Cf. *Hoagland Corp. v. Helvering*, 121 F. (2d) 962, 964 (C. C. A. 2d, 1941).

*Cortland*<sup>40</sup> decisions. It said: "It is obvious that both courts based their decisions not so much on the ground that the short-term purchase money notes were not securities as that the transactions involved were not reorganizations."<sup>41</sup> And it added: "Here, we unquestionably have an interest of the petitioner in the corporation prior to its recapitalization as evidenced by its long-term notes; upon the recapitalization we see that interest exchanged for shares of stock. But the same party holds the interest, although it is carried over to the recapitalized corporation in changed form."<sup>42</sup> This case has been distinguished<sup>43</sup> on the ground of the length of the term of the notes. But why should that make any difference? We are dealing with the transferor's side of the exchange, that is, with the property *given up* in connection with the reorganization. A demand note may be just as sick as a long-term, beautifully engraved gold bond. A demand note may in fact represent a very long and deep "continuity" of interest in the enterprise. In such a case, both notes and bonds, as well as stock, are equally in need, and equally deserving, of the facilities of the reorganization provisions of the statute.

After the *Burnham* decision, the courts have consistently gone the other way. In *Commissioner v. Sisto Financial Corp.*,<sup>44</sup> the taxpayer owned notes in the X Corporation. X transferred all of its assets to Y in exchange for Y's stock, and the stock was delivered to the taxpayer in exchange for his notes in X. In a later year, the taxpayer sold his Y stock, and the question was his basis for computing gain on that sale. He contended that his basis for the notes carried over, and became the basis for the Y stock. But the Commissioner contended that the exchange was not tax free, and that the basis of the Y stock was

<sup>40</sup> *Cortland Specialty Co. v. Comm'r*, 60 F. (2d) 937 (C. C. A. 2d, 1932).

<sup>41</sup> 86 F. (2d) at 777.

<sup>42</sup> *Id.* at 777-78.

<sup>43</sup> *Pacific Public Service Co.*, 4 T. C. No. 87 (Feb. 8th, 1945).

<sup>44</sup> 139 F. (2d) 253 (C. C. A. 2d, 1943), *rev'g*, 47 B. T. A. 425 (1942).

its much lower market value at the time it was received.<sup>45</sup> The Commissioner prevailed. The court cited the *Pinellas* case and concluded: "A fortiori, the demand notes were not securities."<sup>46</sup> It gave no heed to the fact that the notes involved in the *Pinellas* case were received on the exchange, while in the case before the court the notes were on the transferor's side. It did not reexamine the *Pinellas* case to determine whether the opinion there should really be regarded as determining that a note is never a security for the purpose of these statutory provisions.

The most recent expression of this point of view is found in *Neville Coke and Chemical Co. v. Commissioner*,<sup>47</sup> with which this discussion commenced. This case, too, involved a creditor which only sought to take the steps necessary to put its enterprise in order. Again the *Pinellas* case and its progeny were rigidly applied, though the note here was on the transferor's side of the exchange. Again, there was no consideration of the basic question whether this sort of an exchange is not precisely within the essential purpose of the reorganization provisions, and whether that purpose cannot be achieved by a re-appraisal of the "securities" portion of the *Pinellas* decision.

Following the lead of the appellate courts, the Tax Court has reached the same result.<sup>48</sup> In all of these cases,

---

<sup>45</sup> This illustrates the point that the Commissioner wins both ways in many of these cases. If there is an apparent gain on the exchange, he contends that the gain must be recognized and taxed. If there is a loss, the Commissioner presently contends that § 112(b)(3) is not applicable. Although the loss is "recognized," ordinarily a very small portion of it is deductible, because of the severe restrictions on the deductibility of capital losses. But since the loss was "recognized," the property received on the exchange takes the low basis determined by its fair market value, and the Commissioner claims an increased (and wholly artificial) gain on the subsequent sale of the stock.

<sup>46</sup> 139 F. (2d) at 256.

<sup>47</sup> C. C. A. 3d, March 22, 1945.

<sup>48</sup> *Bunker Hill & Sullivan Mining Co.*, 1 T. C. 1057 (1943) (here the taxpayer sought and obtained a deduction for a loss on the exchange); *F. T. Bedford*, 2 T. C. 1189 (1943), supplemental opinion, 44 Prentice-Hall TC Mem. Serv. ¶ 44,123 (Apr. 17, 1944); *Globe-News Publishing Co.*, 3 T. C. 1199 (1944); *Pacific Public Service Co.*, 4 T. C. No. 87 (Feb. 8th, 1945).

the result has been reached on what may be regarded as largely mechanical grounds. The *Pinellas* case is cited, and usually the *Sisto* decision of the Second Circuit Court of Appeals. With it thus established that notes are not securities, the result follows automatically.

The nature of the results reached in these cases is shown by the decision in *F. T. Bedford*.<sup>49</sup> In that case, the taxpayer owned preferred stock in corporation X, which was guaranteed by corporation Y. Both X and Y were reorganized under Section 77B of the Bankruptcy Act, and the taxpayer received new preferred stock in each of the reorganized companies. The Tax Court held that the receipt of the Y stock was taxable, for the reason that the taxpayer had only a creditor's claim against Y, and that was not a "security" within the meaning of the statute.<sup>50</sup>

<sup>49</sup> 2. T. C. 1189 (1943), supplemental opinion, 44 Prentice-Hall TC Mem. Serv. ¶ 44,123 (Apr. 17, 1944).

<sup>50</sup> The tenuousness of the distinction is shown by the decision in *Skenandoa Rayon Corp. v. Comm'r*, 122 F. (2d) 268, 270 (C. C. A. 2d, 1941), that "The stockholders' rights to dividend arrears, if treated as separate from the stock itself, must certainly be considered as 'securities in a corporation a party to a reorganization'— a curious 'security' to be sure, but nevertheless a 'security.'" To the same effect is *Globe-News Publishing Co.*, 3 T. C. 1199 (1944). But cf. *M. W. Ellis*, 3 T. C. 106 (1944), where "conditional rights certificates," representing possible future dividends, were held to be "no part of the capital structure of the company."

Preferred stock, with no voting rights in any event, and redeemable at any time on thirty days' notice, and sooner if the notice was waived, has been held to be "securities." *Schweitzer & Conrad, Inc.*, 41 B. T. A. 533, 541 (1940). The decision seems eminently sound, but it emphasizes the futility of the view that notes are not "securities." The line is hard enough to draw when there is really a reason for drawing it. Cf. Note, *Deductions for Interest under the Federal Income Tax* (1942) 55 HARV. L. REV. 1189.

The phrase "stock or securities" also appears in INT. REV. CODE § 371, relating to exchanges in obedience to orders of the Securities and Exchange Commission. But here someone has seen the problem, and § 373(f) provides that for the purposes of Supplement R the term "stock or securities" means shares or certificates of stock, "notes, bonds, debentures, and evidences of indebtedness. . . ." The Committee Report states that this change was made "In order to facilitate exchanges or distributions in furtherance of the policies

If we cannot look behind the *Pinellas* case, this result follows readily enough. But if we can recognize that no such question was necessarily decided in the *Pinellas* case, and that situations of this sort fall fully within the objectives of the reorganization provisions of the statute, then we can recognize that we have long been blinded by a too narrow construction of the word "security," and we can extend the application of the statute to the very sort of situation to which it most clearly should apply. Is there any reason why a creditor of an embarrassed corporation, no matter how unsecured his claim may be, and no matter what its term, should not be able to participate in working his claim out by exchanging it for stock? Is there any reason why it should make any difference at all in such a situation what the term of his claim is? Should he be able to get a deduction for a loss (if he can use it) merely by converting the form of his claim from debt to stock?<sup>51</sup> When a corporation is wholly solvent, a person having a demand note can get his money promptly. But when the

---

of section 11(b) of the Public Utility Holding Company Act of 1935." SEN. REP. NO. 1567, 75th Cong., 3rd Sess. (1938) 36. There would seem to be no real reason why the rule that notes are securities should be confined to the notes of public utility holding companies. In a very real sense, 373(f) can be advanced as an authority for the view suggested by this article.

<sup>51</sup> Cf. H. R. REP. NO. 704, 73rd Cong., 2d Sess. (1934) 14, which concludes that "the reorganization provisions should be retained" because they "will prevent large losses from being established" where investors "receive securities in a newly reorganized enterprise which are substantially the same as their original investments." SEN. REP. NO. 558, 73rd Cong., 2d Sess. (1934) 16-17, is similar.

The reorganization provisions were originally adopted "in order that ordinary business transactions will not be prevented"; they were intended to apply where there was "a mere change in the form of ownership of the property," and were "based on the theory that the types of exchanges specified . . . are merely changes in form and not in substance and consequently should not be considered as effecting a realization of income at the time of the exchange." STATEMENT OF THE CHANGES MADE IN THE REVENUE ACT OF 1921 BY H. R. 6715 (1924) 6, 10, commonly, though not quite accurately, cited as the Gregg Statement. To the same effect is H. R. REP. NO. 179, 68th Cong., 1st Sess. (1924) 13, 16; SEN. REP. NO. 398, 68th Cong., 1st Sess. (1924) 14-15, 17.

corporation is embarrassed, the holder of a demand note or a book account may be just as inextricably tied up with the situation as if he had a twenty-year non-redeemable bond.

These are intricate problems. They must be considered patiently, and step by step. But the situations in which the statute has been denied application are highly real ones. The argument of this article is that the statute has been denied effect in a situation to which it clearly should apply because of a combination of (1) an original confusion in the *Pinellas* case between the continuity of interest test and the definition of the word "security," and (2) a literal and uncritical application of the construction of that word resulting from the confusion. If there is any merit in these contentions, it is not yet too late to recognize that the lowly creditors of a corporation have an interest fully within the purpose of the reorganization provisions of the statute. Bondholders have such an interest. Stockholders have such an interest. Is there any reason at all why noteholders and other creditors, lying in between, should not have exactly the same status?

ERWIN N. GRISWOLD.

HARVARD LAW SCHOOL.

